Working Paper on

Compensation

December 30, 1995

CAPT Roger T. Argalas, USCG
MAJ Roy A. Burton, USA
LCDR William R. Cloughley, USN
LT Jeffrey S. Dunn, USN
LtCol Kitty L. Fowler, USAF
SSG Adele L. Jackson, USA
LT Frederick M. Oelrich, USN
LtCol Jon M. Vetterlein, USAF
LTC James W. Woodard, USA

CHAPTER 1
INTRODUCTION

An organization designs and implements a reward system to focus employees on the specific behaviors the organization determines necessary to achieve its objectives and goals.

Organizations are designed to accomplish specific purposes. The dynamic resource that enables organizations to survive and succeed is people. Organizations must attract, hire, retain and motivate people who possess the appropriate knowledge, skills, aptitudes, and attitudes. While an integrated human resource management system is required to address all "people needs" of an organization, the primary focus in this working paper is the reward system.

An organization designs and implements a reward system to focus employees on the specific behaviors the organization determines necessary to achieve its objectives and goals. Specific behaviors may range from arriving at work at a designated time and meeting specific performance standards to providing innovative contributions that lead to desired outcomes.

Various motivational theories attempt to explain the effect of rewards on behavior. Some succeed in explaining behavior in general but fall short of explaining the behavior of specific individuals. The perceived value of a reward varies significantly over time and is influenced by lifestyle changes. Designing and managing a reward system that will benefit the organization is difficult and complex.

The purpose of this working paper is to summarize the theories, practices, principles, advantages and disadvantages underlying the elements of a compensation system.

CHAPTER 2
MOTIVATIONAL THEORIES AND COMPENSATION

Introduction

There are numerous studies, research reports, and theories that attempt to explain the complex behavior of people at work. They try to give managers prescriptions for the best way to manage an organization's human resources enabling them to achieve organizational ends. This section briefly introduces a number of motivational theories from the field of industrial and organizational psychology. The first set of theories, called content theories, focuses on the specific factors that motivate people. The second set of theories, the process theories, attempts to explain and describe how people start, direct, sustain and stop behavior. The discussion of these theories will be followed by examples of how they might be used to think about compensation.

Content Motivational Theories

Maslow's Hierarchy of Needs

. . . people spend their entire lives seeking to satisfy certain needs.

Maslow believed that people spend their entire lives seeking to satisfy certain needs. This activity determines and directs human behavior. People proceed from the satisfaction of lower level needs to the satisfaction of higher level needs. This occurs in a specific hierarchical order. *Relative* satisfaction of a lower level need is required before a person can focus on higher level needs. These needs and ways in which they might be satisfied are listed below:

Level 1 – Physiological needs are the basic survival needs for food, water, shelter, sleep, and other physical essentials. Money makes it possible for people to satisfy these basic needs.

Level 2 – Safety needs focus on the need for people to assure themselves that they are relatively safe from the dangers and insecurities of their environment. Money, specifically benefits, generally enables people to satisfy this fundamental need. People often express this need by seeking medical, unemployment and retirement benefits.

Level 3 – Need for belongingness involves the need for social interaction. This is the need to belong to a group, to affiliate with other people, and to be accepted by those with whom they associate. This need is most often satisfied within the context of jobs. People look to the workplace to provide opportunities for finding and establishing interpersonal relationships.

Level 4 – Need for esteem is divided into two aspects. First, people need to experience self-worth, competence, and mastery in their primary areas of activity. Second, people need appreciation, recognition, and respect from others. Leaders often address this need by the use of public recognition and reward.

Level 5 – Need for self-actualization is the highest level need toward which people strive. Once lower level needs are *reasonably* satisfied, people are motivated toward fulfillment of their inner selves or "to become everything that one is capable of becoming." Self-actualized people feel that they have reached their full potential. Managers trying to motivate people in this category may use involvement strategies in planning job design. They make special assignments that capitalize on employees' unique skills or involve employee groups in designing work procedures and plans for implementation.

Maslow contended that most workers in America had already satisfied their lower level or "deficit" needs (for example, the first two levels). Managerial strategies such as increasing income, strengthening job security or enhancing feelings of social satisfaction would not accomplish any worthwhile purpose. Only when individuals performed the type of work that led to satisfaction of their higher level needs for esteem and self-actualization would they be able to make significant contributions to their organizations.

McGregor's Theory X and Theory Y (1960-1970)

McGregor believed that a manager's styles of leading and directing people are very closely related to their belief systems. He offered two diametrically opposed theoretical constructs or fundamental assumptions regarding the behavior of people at work.

Theory X, the traditional management view, calls for firm direction and control of people. It assumes average employees dislike work, prefer to be directed by superiors, wish to avoid responsibility, are relatively unambiguous, are unconcerned about their organizations and are motivated by the need for security. Managers accepting these assumptions will use coercion, fear and threats of punishment to get their employees to produce. McGregor stressed that this approach would achieve minimal results.

Theory Y, this contemporary management approach, rests on the following assumptions:

- Expending effort in work is as natural as play or rest. Depending on a number of conditions, work can either be a source of satisfaction and employees will want to perform it or it can be a source of punishment and employees will want to avoid it.
- Employees will exercise self-direction and self-control to reach objectives to which they are personally committed.
- Commitment to objectives can be achieved through the satisfaction of an employee's ego and self-actualization needs.
- The average person can learn to accept and actively seek responsibility.

. . . work can either be a source of satisfaction and employees will want to perform it or it can be a source of punishment and employees will want to avoid it.

- The capacity to demonstrate imagination, ingenuity and creativity and apply them to solving organizational problems is widely distributed in the work population.
- In most job environments, the intellectual potential of the average employee is only partially used.

McGregor's strategies for implementing Theory Y, which he considered most successful in attaining organization objectives, included delegating more responsibility to employees, broadening their areas of work activity, and allowing people to participate more actively in matters directly affecting them on the job.

Herzberg's Motivation-Hygiene Theory

When people experience true job satisfaction and motivators are activated, they are stimulated to do high-quality work and, thereby, make worthwhile contributions to their organizations.

Herzberg assumed there are two sets of factors present in any job situation: satisfiers and dissatisfiers. These factors are *not* opposite ends of the same continuum. The absence of one set of factors does not indicate the presence of the other factors; in other words, not having job dissatisfaction does not mean having job satisfaction, but merely nonsatisfaction.

Motivators are factors that result in job satisfaction. They relate to the intrinsic *content* of the job and include achievement, recognition, the nature of work itself, responsibility, advancement and a feeling of personal growth. These factors contribute to satisfying Maslow's ego and self-actualization needs.

Hygiene factors are the aspects of a work situation that lead to job dissatisfaction. They are related to the extrinsic *context* of the job. Included in these factors are company policy and administration, supervision, working conditions, job security and salary. Hygiene factors, contribute to satisfying Maslow's lower-level needs.

When people experience true job satisfaction and motivators are activated, they are stimulated to do high-quality work and, thereby, make worthwhile contributions to their organizations.

McClelland's Achievement Motivation Theory

. . . people are motivated according to the strength of their desire to perform in terms of a standard of excellence or their desires to succeed in competitive situations.

McClelland assumed people are motivated according to the strength of their desire to perform in terms of a standard of excellence or their desires to succeed in competitive situations. There are three major characteristics of high achievers: (1) they like to set their own goals, (2) they tend to avoid the extremes of difficulty levels in selecting goals, and (3) they prefer tasks that provide timely feedback. High achievers value money as a strong symbol of their achievement and adequacy, but compensation may create dissatisfaction if they feel it inadequately reflects their contribution. High achievers also get the most from jobs containing high levels of competition.

Process Motivational Theories

Expectancy Theory

Expectancy theory views people as having their own needs and ideas of what they desire from work and its rewards.[1] They use these desires to make decisions about what organization to join and how hard to work on the job. Therefore, people are not inherently motivated or unmotivated; motivation depends on the situation people are facing and how it fits their needs.

. . . people are not inherently motivated or unmotivated; motivation depends on the situation people are facing and how it fits their needs.

There are three elements of expectancy theory: expectancy, valence and instrumentality. Expectancy is the belief that a particular level of effort will be followed by a particular level of performance. Valance is a measure of an individual's feelings about a particular outcome. The product of expectancy and valance determines motivation. Instrumentality is the relationship between performance and outcomes.

On this basis, it is possible to build a model of behavior. An example of one of these models can be found in Figure 1. The model shows motivation as the force that causes an individual to expend effort. Effort alone is not enough. Unless the individual sees that his or her efforts can lead to some performance level, the individual will not put forth much effort. This expectancy of being able to perform at a given level will determine the amount of effort expended. Also, the more an individual believes that a certain level of performance will lead to a desired outcome, the more the person will be likely to perform at that level. This relationship is instrumentality. So it can be seen that in order for an individual to put forth effort, the individual must feel that he or she is likely to perform at that level, and that the outcome associated with that level of performance is desirable.

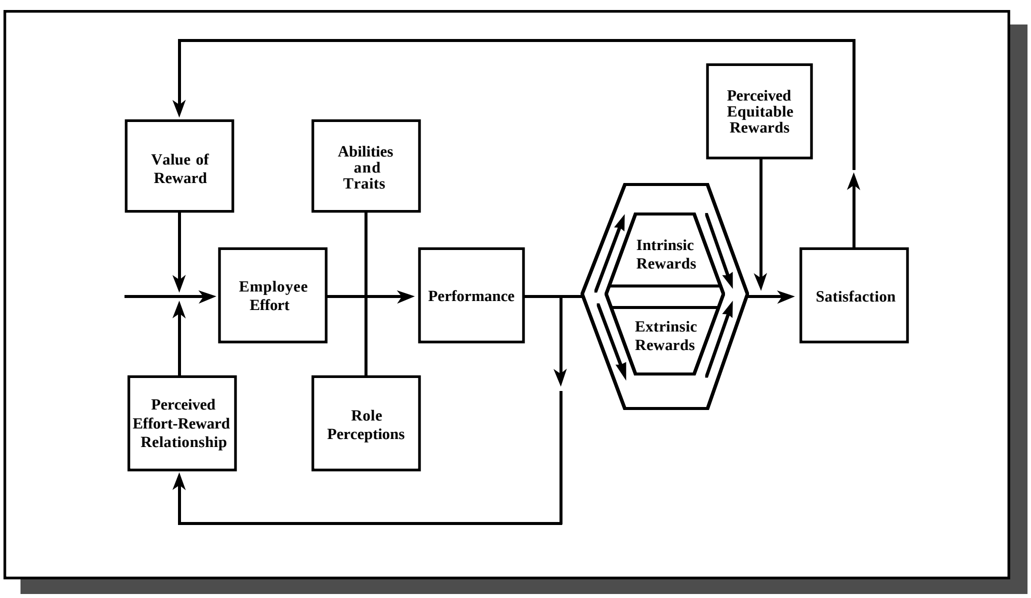


Figure 1 – Integrated Motivation Model

[1] William P. Anthony, Pamela L. Perrewe, and K. Michele Kacmar, *Strategic Human Resource Management* (Orlando, FL: Harcourt Brace Jovanovich, 1993), pp. 431-432.

Equity exists when the ratio of a person's outcomes to inputs equals the ratio of others' outcomes to inputs.

Equity Theory

Equity theory focuses on individuals' feelings of how fairly they were treated when compared to others.[2] The two primary elements of the theory are (1) that people evaluate their social relationships just as they would evaluate buying a car, home or stock and (2) that people do not operate in a vacuum – they compare their own situation with others.

Equity theory considers the relationship of two variables: inputs which are what an individual contributes to an exchange – and outcomes – what an individual receives from the exchange. Equity exists when the ratio of a person's outcomes to inputs equals the ratio of others' outcomes to inputs. Inequity occurs when the ratios are not equal. People who work harder than others, complete work on time and put in longer hours expect a larger outcome or reward. Inequities cause tensions which people will seek to reduce through six behaviors:

- Change their inputs upward or downward.
- Change their outcomes to restore equity.
- Distort their own inputs and outcomes. (This is a mental adjustment to achieve equity. They may say things like "this job is a piece of cake," or "this job is really important!")
- Leave the organization or request a transfer.
- Change their comparison group.
- Distort the inputs or outcomes of others.

An example of an equity theory framework can be found at Figure 2.

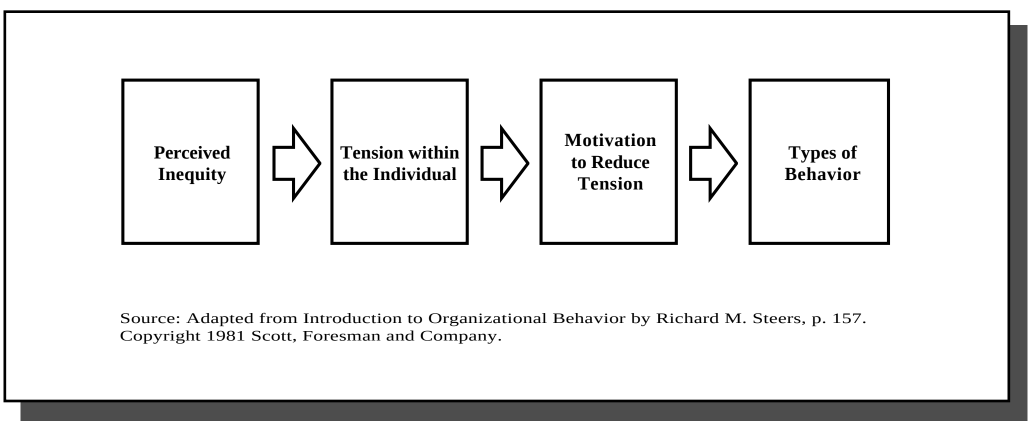


Figure 2 – Motivational Process of Inequity

[2] Anthony, Perrewe and Kacmar, pp. 429-431.

Motivational theories have not enabled all managers to increase the productivity of their employees. Several factors may help to explain the confusion, discrepancies, and paradoxes surrounding the entire work motivation issue. For example, the degree of work motivation varies widely among people. It is difficult to generalize the motivational theories to fit every situation. People vary in their psychological needs, motivational pattern, and values as they do in their abilities, personality characteristics, and levels of mental ability. People have different opinions about the importance of work. For many, a job is the means to an end – for example, getting money to enjoy off-the-job leisure or family activities. Additionally, there has been a significant change in the attitudes of many employees toward work. The overall work ethic is not as strong as it was. The will to work varies widely from person to person. Another reason for the attitude change is the rise in affluence in the nation. Clark Kerr, a noted researcher, made this observation, "hard work leads to affluence, affluence leads to new life-styles, and new life styles diminish the work ethic." Finally, there has been an increase in government social support programs.

Motivational theories have not enabled all managers to increase the productivity of their employees.

Extrinsic vs. Intrinsic Rewards

The difference between intrinsic and extrinsic rewards is another important concept in understanding compensation theory. Extrinsic rewards are those things that originate outside the individual. They are things like pay, benefits and awards – things the employer gives directly to the employee. Intrinsic rewards originate *inside* the individual; they are rewards that people give themselves. They are largely independent of an organization's formal compensation program and depend more on employees' needs and the work they do. Jobs that are interesting and challenging and those that provide opportunities for growth and development are said to be jobs that are intrinsically rewarding. That is, an employee can reward or compensate himself or herself by just performing the work. Management can not provide intrinsic rewards to employees, only the opportunity for employees to reward themselves in this way. Both extrinsic and intrinsic rewards are important in the design of a compensation system.

Example of Theory Application

McCoy[3] provides one perspective for integrating extrinsic and intrinsic rewards and motivational theory into a complete system. McCoy's concept – Behavior Based Incentive Compensation – is summarized: "Maslow and Skinner have shown us that the human drive to fulfill specific needs will produce specific behavior. It is widely accepted that specific behavior will produce specific results. By identifying the desired results in specific terms, an organization can work backward and identify the behavior that will generate those results. Next, it must identify the employees' intrinsic and extrinsic needs that are within the organization's power to fulfill. By providing the opportunity to fulfill those needs, and by making such an opportunity contingent upon the specific performance that has been identified, it is possible to link the needs of the employees and the organization."[4]

---

[3] Thomas J. McCoy, *Compensation and Motivation* (New York, NY: AMACOM, 1992).
[4] McCoy, p. 85.

Both extrinsic and intrinsic rewards are important in the design of a compensation system.

The author proposes a system that combines both intrinsic and extrinsic aspects into a "fishbone diagram" (Figure 3). The diagram has two sides. One side represents the employees' needs, the other the needs of the organization. The employee side is divided into extrinsic and intrinsic parts.

The intrinsic part, found in the upper left of the diagram has three sections: empowerment, positive reinforcement and focus. These are defined as follows:

- *Empowerment:* reflects the basic need to feel in control of one's own environment.
- *Positive reinforcement:* represents the basic human need for achievement and accomplishment and the reassurance those provide to self esteem.
- *Focus:* reflects a sense of purpose and direction.

The bottom left portion represents the employees' extrinsic needs. This part is divided into three sections: How-Pay, What-Pay and Why-Pay. The important idea here is that the satisfaction of the extrinsic needs listed in the bottom left cause or foster the environment that leads to the satisfaction of the intrinsic needs in the upper left. For example, the Why-Pay rewards can give an individual focus – such as, paying for specific goals – and some positive reinforcement; the What-Pay rewards give positive reinforcement and some empowerment – namely, it lets the employee make a cost-benefit comparison.

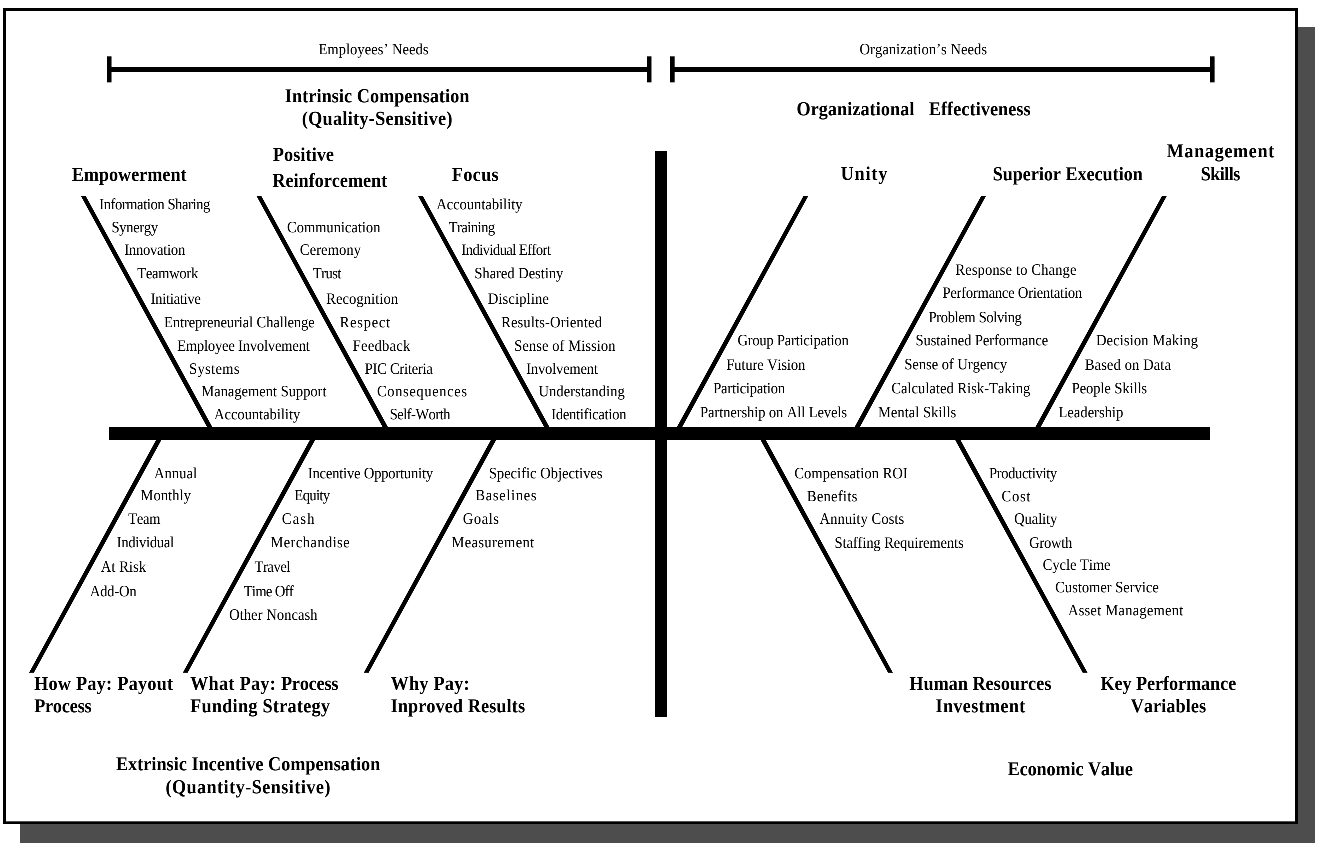


Figure 3 – The Congruent Fishbone Diagram[5]

[5] McCoy, p. 114.

The organization's needs are divided into two sections on the right-hand side. The top section is somewhat analogous to the intrinsic needs of the individual. These are the organization's needs as they pertain to organizational effectiveness and are divided into unity, superior execution and management skills. The bottom right quadrant represents the organization's economic or "extrinsic" needs: human resources investment and key performance variables.

The author proposes that the senior managers of an organization choose the fundamental objectives they wish to attain. These can be used to fill in the right-hand side of the chart. The next step is to design a compensation and management system in such a way that the employees' intrinsic needs are fulfilled through their efforts in helping the organization reach its objectives.

Compensation Team Framework

After analyzing the theoretical background, the Compensation Team devised the following framework to think about the compensation process.

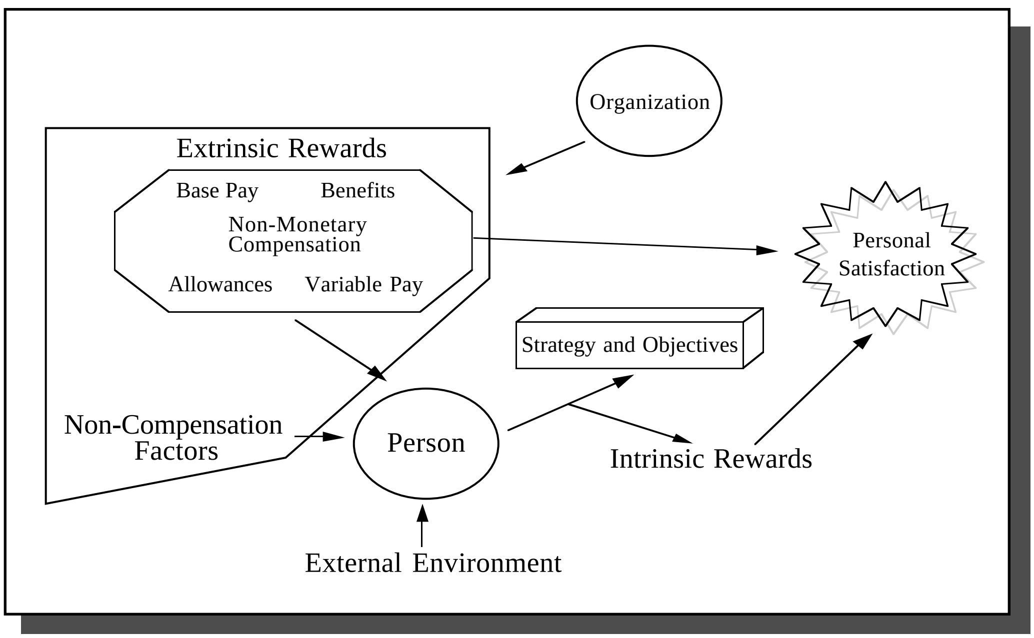


Figure 4 – Reward Framework

Organizations have many ways to get employees to work for them. The most obvious way is through the reward system, more specifically through extrinsic rewards. These rewards cause the employee to work for the organization and, by meeting some individual need, will provide some level of personal satisfaction.

However, there are also factors, not directly related to the amount of extrinsic rewards that affect the employee. These include the environment as well as things like positive peer relationships, feelings of ownership and empowerment, availability of status symbols, etc.

These *non-compensation factors*, affect how the person perceives and does the job, just as the extrinsic rewards do. When all of these means are applied effectively, the person receives intrinsic rewards through working for the organization. The intrinsic rewards further increase the level of personal satisfaction. It can be seen that there is more to creating personal job satisfaction for employees than just providing extrinsic rewards through the compensation system. In order for this to be most effective, the organization must also have a personnel system and management culture that provide these non-compensation factors.

CHAPTER 3
COMPENSATION PROGRAMS

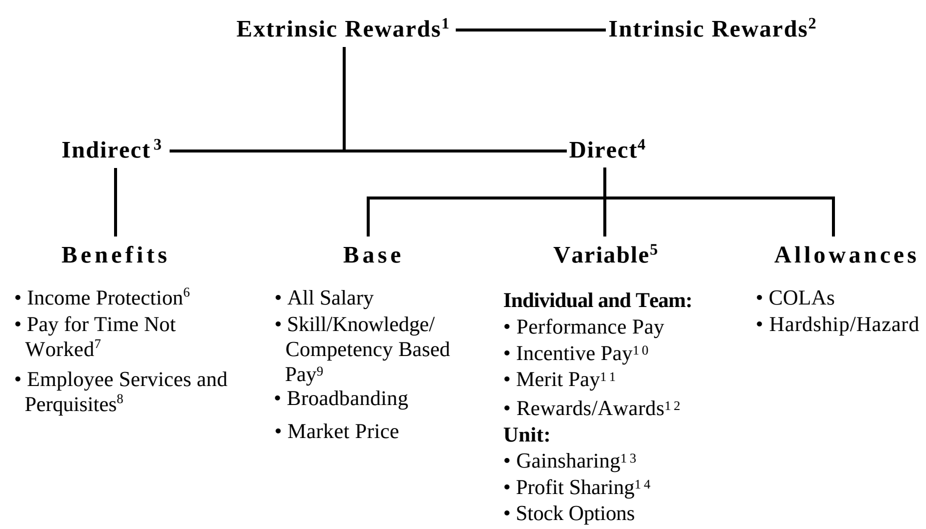
Introduction

. . . a total compensation program consists of extrinsic rewards and intrinsic rewards . . .

"The reward system of an organization includes anything that an employee may value and desire and that the employer is able or willing to offer in exchange for employee contribution."[6] The components of a total compensation program consist of extrinsic rewards and intrinsic rewards as described in Chapter 2. Two types of extrinsic rewards will be covered in this chapter: direct and indirect rewards.

Direct rewards or pays are tangibly given in terms of cash or financial expenditures as payments to employees for time worked or results obtained. There are three types of direct pay: base pay, variable pay and allowances. (Allowances are not discussed in this paper as the literature focuses on the private sector policies and practices that do not use allowances as extensively as the military.) Indirect pays are expenditures that are made for the benefit of an organization's employees. Indirect compensation programs are often referred to as the "fringe benefits" or "employee benefits" programs.

[6] Richard I. Henderson, *Compensation Management,* 6th ed. (Englewood Cliffs, NJ: Prentice Hall, Inc., 1994).



1 Rewards provided by the organization in which work is performed.
2 Rewards people give themselves primarily through emotions such as a feeling of accomplishment. Management can not provide these rewards only the opportunities for employees to reward themselves.
3 Remuneration not found in the paycheck.
4 Remuneration found in the paycheck.
5 Remuneration that is not guaranteed and that varies. It is generally in addition to base pay.
6 Examples are life, travel, accident, disability and medical insurance and retirement plans.
7 Examples are paid lunch hours, paid vacations, maternity leave.
8 Examples are food service subsidies, educational assistance, company cars, recreational facilities.
9 Base pay levels are dependent upon the skills and abilities of the person as opposed to the job requirements.
10 Remuneration designed to incentivize performance. Examples are commissions, performance bonuses, profit sharing, gainsharing. Incentives are predetermined; goals and rewards are known and results are measurable.
11 System that awards periodic, permanent pay increases based on individual performance as measured by the appraisal system.
12 Either monetary or nonmonetary reward based on performance and may or may not be predetermined. Examples are spot cash awards, vacations, suggestion program certificates, service awards or trophies.
13 Bonus based on gains in productivity, quality, cost effectiveness, etc., for the "local" organization, not corporation profits.
14 Bonus opportunity tied to the entire organization's financial performance.

Figure 5 – Breakdown of Reward Types

Base Pay

Organizations may use base pay to reflect the economic, competitive market, and strategic value of jobs or skills. Base pay helps organizations to reflect the relative importance of jobs, compete economically for talented people in the external market, and acknowledge differences in performance among people. Other pays, including indirect pay, are often computed as a percentage of base pay.

Base pay programs in traditional organizations focus on the individual employee, the job assigned, and the next higher job in the hierarchy. Employees become focused on themselves and close internal relationships around them. Their most pressing concerns are vertical career growth and internal job and pay relationships rather than horizontal job and skill opportunities. Individuals compete to expand their control of people and resources as a way to add greater value to their job.

Base pay is not an effective reward for performance . . .

In most businesses today, base pay follows industry practices without much concern about the impact on organizational performance. Base pay costs are allowed to increase without regard to improvements in performance, quality and productivity. The driver for base pay is competitive practice and internal equity. Base pay is not an effective reward for performance because it ignores the importance of overall organizational results; it is most often viewed by employees as an entitlement. It focuses on the individual and not teams; therefore, it is generally ineffective as a reward for work that is best accomplished in teams.

As organizations move into the future, base pay will accomplish three goals. It will reflect changes in the economics of the labor markets in which the organization elects to compete for talent; serve as the foundation of variable pay; and reflect either the economic, market or strategic value of jobs.

Base pay effectively represents the market value of jobs or skills. Jobs and skills that have greater external market value receive higher base pay. In the future, base pay will need to respond to changes in the external market. It will also be used to control costs so that the organization is not placed in a disadvantageous competitive position by having excessive fixed labor costs.

Base pay levels are determined in many ways, but generally they are based on the level and experience required of the job and performance in that job. As more organizations move to flatter structures and team-based cultures, two other programs are becoming more widely used in structuring base pay: **competency-based pay**, broadly used to include skill-based/knowledge-based/mastery-based, and **broadbanding**.

Competency-based pay rewards employees for particular skills or knowledge or competencies and job related behaviors. These programs provide organizational flexibility by developing a pool of employees capable of working in multiple jobs. Managers can increase rewards to employees based on skill acquisition and lateral movement instead of promotions. These programs support an organization's ability to base pay on the person, not the job, and are easily used in pay for performance programs.

Broadbanding is a program that consolidates a number of salary ranges or levels of base pay into fewer and wider pay bands. Pay varies among individuals within a band based on an individual's skills, knowledge and experience, and individual or team performance.

Increases in base pay are still widely based on a merit system. Theoretically, this merit pay system gives the best performers a larger increase than average performers and average performers larger increases than marginal performers. Statistical studies do not support this claim. As an example, a two percent difference between base pay increases granted to a "average" and "best" employee will not have a long-term effect on both the employees total compensation and the cost to the organization.[7]

---

[7] Jay R. Schuster and Patricia K. Zingheim, *The New Pay: Linking Employees and Organizational Performance* (New York, NY: Lexington Books, 1992).

Employees usually view this pay increase as too small to reflect the difference in performance and to make excellent performance worthwhile. A number of studies indicate that the percent increase would need to be about ten percent in order for employees to believe that exceptional performance is worth the effort required to achieve it.[8] Many firms have merit pay as part of their pay for performance program. In the future, employees may not be guaranteed an annual, or any, pay increase. Pay increases will be given only if the organization can afford it and the employee's performance warrants it.

In the future, employees may not be guaranteed an annual, or any, pay increase.

Another idea for organizations to get the most out of increases to base pay is to create from proposed base pay increases an amount of potential base pay that is at risk. An employee would get the potential base pay at risk if they meet or exceed performance targets. Once the funds are designated as potential base pay at risk, they are part of variable pay because they are contingent on performance. Employees may also increase their base pay in competency based systems by acquiring new competencies.

Questions to consider when setting strategy for future base pay:

- What should the organization expect from employees in exchange for base pay?
- What factors should determine the level of base pay paid within the organization? The labor market? Internal equity across the organization? Internal equity within broad functional areas? Job content? Skills? Individual performance? Organizational performance? Strategic value of jobs to business goals?
- If competitive practice should play a role in determining the level of base pay, what should constitute competitive practice?
- How should the value of jobs be determined using the elements under the various options such as skill-based, strategic value of jobs or internal equity?
- How should the organization determine how it benefits from base pay?
- What should be the basis of any base pay increase granted?
- If merit pay is to play a part in granting base pay increases, what role should it play?
- What criteria and methodology should be used to appraise employee performance?

There are two primary factors that form the basis of pay: pay for the job and pay for the person. Pay for the job is based on a job description, job evaluation, and job appraisal system. It is prevalent in hierarchical organizations. Pay for the person seeks to separate the person and their skills from the specific aspects of the job they hold. The following sections will cover these two factors in greater detail.

---

[8] Edward E. Lawler III, *Strategic Pay: Aligning Organizational Strategies and Pay Systems* (San Francisco, CA: Jossey-Bass, 1990).

Paying for the Job

Introduction

Job-based pay typically rests upon the foundation of a job evaluation system. In designing and implementing such a system, the first step is to identify the work content of each job and the requirements of the jobholder. The organization must be able to accurately and precisely identify the required responsibilities and duties, education, experience and skills necessary to perform these assignments. Management must also address the conditions under which tasks are performed in order to compensate based on job content and performance. This analysis must validly measure and differentiate job and performance requirements so that all employees receive fair and equitable treatment. There are a number of advantages, disadvantages and conditions that should be considered when implementing job-based pay.

Job-based pay typically rests upon the foundation of a job evaluation system.

Advantages

- Can pay people the same rate for comparable job duties regardless of where they are in the organization.
- Is simple to understand and easy to administer, once it is in place.
- Ensures market competitiveness.
- Avoids the difficulties of moving to a skilled-based pay system.
- Makes moving from one part of the organization to another easier.
- Allows for centralized control of pay systems and costs.
- Gives the appearance of objectivity because it is usually based on complex quantitative methods.

Disadvantages

- Provides little, if any, opportunity for variation based on individual performance, experience or skill.
- Promotes bureaucratic management style.
- Reinforces hierarchy.
- Depersonalizes value orientations and establishes the principle that people are only worth what they do rather than who they are and what they can do.
- Fosters internal focus and impairs a strategic orientation.
- Is very labor intensive, initially.
- Potentially inflates the pay system's operating costs. Employees will build job descriptions to get more pay.
- Does not encourage skill development.

Conditions Under Which Job-based Pay Works Best

- Organizations that desire high levels of internal equity or pay comparability.
- Union jobs, for example, electrician or welders.
- Temporary or apprentice jobs, for example, clean-up crews after major disasters.
- College interns.
- Sales representatives for the "fixed" portion of their pay.

Conditions Under Which the Job-based Pay Does Not Work Well

- Organizations where people are rewarded and respected for their expertise and ideas, not for the "value" of their jobs.
- Environments of rapid change.
- Hierarchies that encourage the best and brightest to move up.

Discussion

To implement this type of pay system, basic employee groups must defined, according to their values, pay needs, skills, and the strategic role each group will perform in the organization. Next, the organization must effectively convey strategic role messages to each group, keeping in mind that the message should be consistent with their cultural values and needs. Three assumptions lie at the heart of this type of pay system:

- Every employee belongs to a basic group.
- The role of each basic group, though differentiated in pay, is important to organizational success.
- When used properly as management tools, the company's compensation plans communicate and reinforce what that role is and how well it is being accomplished.

Employers must remember that base pay serves as the economic foundation for employees. It provides security and must be delivered with regularity. It should be relatively inflexible and adjusted periodically to offset the effects of inflation and to keep pace with the market. Essentially, it is compensation for being competent in a job – for possessing the knowledge and talent to do the job and applying that knowledge in a proficient and productive way.

Employers must remember that base pay serves as the economic foundation for employees.

Not all jobs have the same value. Differentiating base pay for various jobs establishes a hierarchy of value within the company. This differentiation is usually based purely on the results of a job analysis program. This is an analysis of job

Differentiating base pay for various jobs establishes a hierarchy of value within the company.

activities, tasks, and behaviors which involves compiling a detailed description of responsibilities and duties, determines the relationship of the job to technology and market data, the amount of knowledge required to prepare for and perform the job, accountabilities and the conditions under which the job is performed. Job analysis also involves the identification, collection, classification of task statements and job behaviors. A list of tasks provides a detail analysis of what the incumbent does in performing the various job activities, whereas the job behaviors provide insight as to what can be considered acceptable or unacceptable behavior.

Since job-based pay is directly linked to job value, a hierarchy of job values provides a significant opportunity for employees to increase their earning power over time through promotions. However, the recent trend toward flatter organizational structures suggests there may be fewer promotions available in the future.

Job-based pay motivates in two ways – one positive, the other negative. When employees know that another job carries a higher base pay, they are motivated to work toward a promotion. At the same time, because base pay compensates for being competent, workers will maintain competency or risk losing their jobs. The pay components and weight for each strategic group of employees will vary based on the role assigned to that group and the results, activities, or behaviors expected.

Paying for the Person

Introduction

Paying for the person can be based on any personal characteristics: the person's value in the marketplace, skills, education, knowledge or experience, family status, age, seniority within the organization, or any other characteristics one might imagine. The most widely used method of pay for the person is *skill-based* pay. More recently, emphasis on strategic planning for competitive advantage and limitations of skill-based pay have given rise to *competency-based* pay.

As organizations have downsized and restructured, they have sought new ways of paying people that are congruent with the new structures.

One reason these kinds of pay are receiving emphasis today is that companies' reactions to increasing global competition over the past thirty years have reduced the viability of the "job" as the basic unit of organizational structure in this country. As organizations have downsized and restructured in order to be competitive, they have sought new ways of paying people that are congruent with the new structures. For example, organizations must have the flexibility to respond quickly to innovative competitors in order to provide existing products at lower cost or bring new products to market efficiently – or must have the flexibility to *be* the low-cost producer.

The organization must be able to assign people to new jobs or tasks easily and efficiently. A system requiring detailed evaluation of each facet of a job needed to produce a product may be too slow to respond to changing job requirements because it simply takes too long to develop job descriptions – the tasks may come and go too fast.

As a result, companies are shifting their focus from *jobs* to *people*, with the skills and competencies they possess, as a more stable basis for structuring the organization.

We discuss both skill-based and competency-based pay, then some possible applications to human resource management in the military.

Skill-based Pay

In skill-based pay, the starting point for an individual's pay is the *mix and depth of skills* rather than the *job*.

The essential requirement of skill-based pay is that the organization be able to determine which skills ought to be rewarded. The organization has to identify the tasks that need to be done, the skills needed to do those tasks, and it has to place a dollar value on those skills. Then, the organization has to determine the number and types of skills each employee can be rewarded for learning, explain the system to the employees, and, finally, pay for those skills that employees learn and are willing to perform. Payment may be per skill or for a collective combination of skills; it may be a lump sum payment or continuous. There must be a mechanism for assessing the skills of each employee, and the plan should consider both horizontal and vertical learning. Payment could also include a pay-for-performance element by paying according to how well the skill is performed.[9]

The use of skill-based pay is widespread and increasing. The proportion of Fortune 1000 companies using some form of skill-based pay has increased from 40 percent in 1987 to 60 percent in 1993, a fifty percent increase.[10]

Skill-based pay is most appropriate in new, high-involvement organizations – that is, where there is a high degree of employee participation in management. The reason is that this system works best when employees help identify the skills that would be most beneficial to the organization. Skill-based pay is easiest to implement at the start-up of a new organization; or in a company transitioning to a more participative management style. It is most applicable when the organization's performance depends on coordination and teamwork.[11]

. . . this system works best when employees help identify the skills that would be most beneficial to the organization.

The primary limitation of skill-based pay is that, while it is relatively easy to identify and measure needed skills for technical or repetitive work (for example, as in manufacturing or in paperwork processing functions within financial institutions like insurance companies), it is very difficult to do so for managerial, staff support, or other "knowledge-based" work. Further, there is the danger that paying for lateral or downward skills may not keep managers on the track for advancement. A principle of human resource management appears to be that *all components of human resource management must adjust to maintain alignment with organizational strategy when any one component (such as the pay system) changes.*

Lawler[12] points out an interesting concept: that paying for skills could permit one to eliminate pay increases solely for promotions – the increases would come from learning new skills, instead. He argues that people ought to be taking new jobs

[9] Lawler, 1990.
[10] CEO, 1995.
[11] Lawler, 1990.
[12] Lawler, 1990.

(promotions) because they are capable of and eager to do the work; not for the pay associated with the new job.

Finally, like paying for the job, the heaviest cost is in initially setting up the system. Once skills are identified and evaluation mechanisms devised, maintenance costs are relatively low as long as the needed skills are stable over time.

Advantages. The two main advantages of skill-based pay have to do with horizontal flexibility and what might be termed "employee empowerment."

Horizontal flexibility. If employees know multiple aspects of the business, they can shift around as needed to fill temporary overages and shortages, enabling leaner staffing. Giving employees some control over their pay can also result in lower turnover and absenteeism.

The greatest advantage comes when skill-based pay is combined with participative management, because they reinforce one another.

Empowerment. The greatest advantage comes when skill-based pay is combined with participative management, because they reinforce one another. As employees learn more about how the whole business operates and how their work affects other parts of the organization, they can develop the ability to solve systemic problems more efficiently, and they can develop a greater sense of commitment, both of which can increase intrinsic motivation. Allowing and encouraging employees to learn horizontal *and* vertical skills increases the potential for self-management. The organization can have a flatter structure that can reduce management overhead and costs.

Disadvantages. The main disadvantage is that skill-based pay generally results in higher pay rates and, therefore, in higher personnel costs – which may have to be offset by employing fewer workers. If a lot of employees are simultaneously learning new skills, productivity may decline in the short run. Skill assessment may have to occur frequently and may need difficult-to-implement peer-level assessment. However, it would seem that if there is a corresponding increase in productivity, *net* costs ought to be lower. The lack of conclusive statistical evidence for the success of skill-based pay may be partly due to the fact that most of the costs tend to be incurred in the near term while most of the benefits are longer-term.

Another disadvantage is that people are still subject to discontent on having "topped out," if there is an upper level to the number of skills they can learn and be paid for. There may be a tendency for employees to want to "job hop;" therefore, a "payback" period may be required; it is difficult for people to remain current in a multitude of skills at the same time because skills may atrophy if not used; and there is a problem with what to do when the skill upon which an employee's pay is based becomes obsolete. [13]

Competency-based Pay

Competency-based pay is the natural evolution of skill-based pay and can be thought of as "skill-based pay for knowledge workers." [14] This evolution manifests itself in a broadening of the concept of skills (to "competencies") and in tying competency-

---

[13] Lawler, 1990.
[14] Ledford, 1995.

based pay to strategic goals that have long-term significance for an organization's viability ("competitive advantage").

The success of many companies in the face of global competition in the 1980s and 1990s has been linked to their focus on the acquisition and development of "core competencies." [15] Core competencies can be thought of as the fundamental things an organization does well – well enough to give it a competitive advantage over other organizations. They are "bundles of competencies" that no one individual possesses, but that develop within an organization over time, measured in decades, and whose key characteristic is that they generate enduring value to the customer. It is the long-term nature of these characteristics that lends promise to the notion that "competencies" may have potential to replace "jobs" as the basic unit of organizational structure.

The logical extension of core competencies is *individual* competencies – the competencies that individuals develop that together constitute the organization's core competencies. The question that each organization must answer for itself is how to translate its core competencies into competency requirements for individuals. Competencies have been defined in several ways, but all definitions have in common that they include a broader array of possible qualifying characteristics than just "skills." The emphasis is more on *how* skills are used rather than what the skills themselves are: competencies are *any* characteristics of an individual that can be tied unequivocally to productivity of the organization. Some other definitions:

- Competencies are "demonstrable characteristics of the person, including knowledge, skills, and behaviors, that enable performance." [16]
- A competency is "an *underlying* characteristic of an individual which is *causally* related to *effective* or *superior* performance in a job." [17]
- Competencies are "individual performance behaviors that are observable, measurable, and critical to successful individuals or corporate performance." [18]

The rationale for competency-based pay suggests some practical considerations for any organization contemplating its use. Foremost is the necessity that the individual competencies an organization defines must be directly related to the strategic goals of the organization. This requires that the organization engage in strategic planning prior to implementing a competency-based pay system. Perhaps the most difficult part of the process is correctly identifying the necessary competencies – there is no tried-and-true methodology for doing this in the literature; organizations must figure it out for themselves.

. . . the individual competencies an organization defines must be directly related to the strategic goals of the organization.

There is a considerable body of research that examines the characteristics of recognized high performing individuals that relate directly to job performance. The research has documented detailed descriptions of competencies and how to evaluate individuals to determine to what extent they possess the competencies. [19]

---

[15] Prahalad and Hamel, 1990.
[16] CEO, 1995.
[17] Hay-McBer, 1990.
[18] ACA.
[19] Hay-McBer, 1990.

The challenge for the organization is two-fold: to "personalize" the competencies to the organization to create a unique set of competencies for the purpose of establishing a competitive advantage; and to correctly identify the core competencies that the organization does not possess now but will need to possess in the future, and for which there may be no existing models of high performance.

A final caveat is that competency-based pay does not address how to motivate work *effort* in an employee, and so should not be confused with "pay-for-performance." A competency-based pay system would still need pay-for-performance elements if the organization wants to incentivize individual performance.

Application to the Military

The current military approach to pay appears to be person-based, but not particularly *skill*-based. Military pay is person-based pay in that:

- Members are paid levels almost completely independent of the specific job the member holds.
- Pay is differentiated by marital status (in the allowances).
- *Longevity* and *rank* together determine the majority of military pay.
- Education is indirectly rewarded via the promotion system and commissioning requirements.

Why is military pay based on these characteristics as opposed to job, skill or competency? One might conjecture that the military early on naturally focused on individuals rather than jobs because such a focus best fits the nature of warfare. Principles of egalitarianism and paternalism have also played a role in the development of our military compensation system. And, it is easy to understand, measure, and predict the manpower costs of our military – a budget concern.

Does military pay have to be this way? Perhaps not. New Zealand, for instance, has implemented a skill-based pay system for its defense forces. In addition, some of the earliest research into competencies was based on studies of the military.

Future DoD strategy may require more flexibility than currently exists in our human resource management system.

Future DoD strategy may require more flexibility than currently exists in our human resource management system. Because the components of human resource management should be related to organizational strategies, other changes to the way the uniformed services manage people may require changes to the compensation system. For instance, the different strategies needed to effectively operate the different parts of an organization as large and diverse as the Department of Defense may lessen the historical need for pay egalitarianism.

Could military culture support a competency-based pay system? Such a system would require integrity, objectivity, commitment to maintaining standards – all these are values that military members adhere to. It requires a strong link to widely embraced strategic goals. It would be difficult to argue that the military should not support this requirement.

Pay for Performance

Introduction

"Pay for performance" refers broadly to any compensation paid to individuals or groups for the purpose of improving individual or organizational performance. Most often these are in the form of variable pay incentives, such as profit-sharing, gain-sharing, or bonus plans. Other types of pay that may have elements of performance pay are merit pay, promotion pay, and deferred compensation.[20] Historically, pay has been and is even now mostly based on the time an employee spends on the job rather than for either the labor input provided or the output produced.[21] Theories of motivation suggest potential for increasing the productivity of employees by providing specific incentives. The obstacles to doing this effectively, however, are many. This section explores the theory, practice and empirical evidence related to pay for performance.

Theory

Economic theory suggests that individuals should be paid a wage equal to the value of the work they perform (their marginal product). Employers can just cover the costs of staying in business at that wage level, while employees could quit and work elsewhere if an employer were not willing to pay that wage.

In practice, the wages that employees are paid deviate from the "values of their marginal products" for many reasons. The most notable, for the purposes of this discussion, is that there are costs involved in monitoring and measuring output of employees; indeed, in many cases, output is impossible to measure directly at all. When employee output is easily measured, as in the case of a salesman or of a worker producing a final physical product from some raw materials, a piece-rate variable pay incentive system is common. But these situations cover a small proportion of all work.

Workers supply two resources to their employers: *availability* and *effort*. Traditionally, organizations pay for availability – either directly for time spent on the job or implicitly – and assume a certain level of effort will accompany that employee's presence on the job.

"Pay for performance" focuses on ways of increasing the effort that employees put into their work. The basic theory is fairly simple and intuitive: Rewards from work are a benefit to employees, while work effort itself is a cost. Work effort is a cost because takes the place of other things a person could be doing (for example, relaxing, doing personal tasks, gossiping with co-workers); additionally, hard work may require longer recuperation or a need for "unwinding" after work, again creating opportunity costs. Therefore, employees will supply effort to the point that the cost of any additional effort is greater than the benefit to be gained from exerting that effort.

"Pay for performance" focuses on ways of increasing the effort that employees put into their work.

It is obvious from this formulation that if no rewards are associated with work effort, no effort is likely to be forthcoming. This implication is accompanied by

[20] Hogan, 1995.
[21] Blinder, 1990.

several others. If work effort *is* rewarded, then people who like to work, or for whom the cost of work is relatively low, will be attracted to and gravitate to those organizations. Similarly, if work effort is rewarded, hard workers will tend to remain in those organizations that reward it.[22]

In theory, then, rewarding employees for performance should draw forth greater effort. However, the theory is limited in its ability to predict whether it would be worthwhile for an employer to pay for performance. In particular, the theory says nothing about whether the costs of implementing a program will be less than the productivity gains the program produces.

It is important that a pay for performance program incentivize performance that will actually benefit the organization – the incentives of the employees must be aligned with the organization's goals. Further, people vary in their responsiveness to incentives, as well as in their potential for increased productivity. Finally, it may be that other aspects of the personnel management system impose a drag on worker performance such that changing those may be more efficient than increasing explicit rewards. Following are some of the theoretical problems surrounding pay for performance:

It is important that a pay for performance program incentivize performance that will actually benefit the organization . . .

Free riders. The "free rider" problem can exist when group performance rather than individual performance is the basis for rewards. Because an individual member will benefit from the efforts of every other member of the group, the reward for the individual member is less directly affected by that member's performance. Therefore, the individual has an incentive not to supply additional effort, but to be a "free rider" on the efforts of the other members. The presence of free riders will reduce the gains from paying for performance.

Moral hazard. If individual performance is rewarded in such a way that comparisons are made to the performance of other workers, then there may be some incentive to direct effort at subverting the performance of other workers rather than increasing one's own level of performance. One can envision this happening in competition for promotion, for example.

Risk. People generally prefer certainty over uncertainty when it comes to pay, yet they would be willing to risk some portion of their pay for the potential of increased rewards. If all pay is at risk, employees may not be motivated because they perceive a danger that they may lose pay due to circumstances beyond their control. The challenge is to design a pay system that correctly balances base pay with pay "at risk."

Codetermination. The term "codetermination" refers to what is also called the "principle-agent" problem – that the interests of the employee are not necessarily the same as those of the employer, or the organization. The incentive system must do more than incentivize effort; it must also ensure that the effort is directed toward achieving the goals of the organization. In theory, if workers have information that employers do not have or that it would be costly for them to obtain, then it may be possible for workers to supervise themselves more efficiently than for the employer to do it. This is one argument for employee empowerment.

[22] Hogan, 1995.

Rewards may be demeaning. It has been argued in one segment of the psychology literature[23] that *any* rewards contingent on performance – whether "carrots" or "sticks" – demean the employee and, while they may work in the short run, eventually cause the worker to dislike the task and do not work in the long run.

Motivational theories offer additional insights into understanding the way in which rewards effect the behaviors of people. Content theories, which pertain to factors in the workplace that motivate behavior, include Maslow's needs hierarchy, developed further by Alderfer, and Hertzberg's motivation factors, developed further by Hackman and Oldham.

Lawler's work in this area noted that management and human resource management systems must interact in a positive and dynamic manner, or rewards will have only minimal influence on employee behavior. There is little doubt that if managers could hire the right person for each job (properly match employee knowledge, skills, and abilities) and the right person to match the organization's culture (select individuals with the values that are similar and reinforce organizational values), the reward system would operate much more efficiently.

. . . management and human resource management systems must interact in a positive and dynamic manner, or rewards will have only minimal influence on employee behavior.

Process theories, those which attempt to explain and describe how people start, direct, sustain and stop behavior, include Skinner's "operant behavior," Vroom's expectancy theory, and Adams' equity theory. Together they indicate that more motivational value can be achieved by a pay for performance program when the employee recognizes a direct link between activities performed, results achieved, and rewards gained. Motivational value also increases when the delivery of rewards closely follows the demonstration of behavior, the completion of an assignment, or the achievement of a result.

Hackman and Oldham[24] describe task-related intrinsic motivation as accruing to individuals who experience, meaningfulness, autonomy, and feedback on the job. Thomas and Jansen[25] build on this theory to describe intrinsic motivation in terms of the worker's feelings of choice, meaningfulness, competence, and progress.

Practice

Because individual performance is often difficult to measure, pay for performance is most often concerned with generating increased *organizational* productivity by linking variable pay, in the form of incentives and awards, to desired employee behavior, contributions or results. Pay for performance programs have little positive effect if (1) little trust exists in the program and in the way it is administered; (2) the organization fails to communicate the procedures to be followed; (3) policies are not developed that relate specific pay increases with particular levels of employee performance; and (4) performance ratings are viewed as being biased or relating poorly to actual performance.

[23] Kohn, 1994.
[24] Hackman and Oldham, 1975.
[25] Thomas and Jansen, 1995.

Pay for individual performance. This type of pay for performance is a basic practice in traditional organizations. It fits well when the work environment values individual jobs and uses job descriptions, job evaluations and appraisal systems. In the perception of employees, being rewarded for individual performance is an issue of equity and fairness. Individual rewards can motivate employees if they are designed and administered properly. These rewards may also help an organization attract and retain employees who are high performers. The key to a successful pay for individual performance is the establishment of an effective system to measure performance and a clear relationship between performance and rewards.

Pay for team performance. If an organization uses teams as the approach for work design, it is appropriate to create systems that reward team performance. An objective of such a reward system is to reduce competition between team members for rewards. In most cases, it is desirable that team members get the same size bonus or salary increase. Rewarding teams works best when their performance is easily measurable and where the work requires a high level of team behavior. When a team is primarily self-directed and responsible for a complete product or process, an organization may be able to use a gainsharing plan for the team. Organizations may also use merit pay based of performance appraisals. Team members can provide input that will affect the level of individual reward. Congratulations and social recognition from the other team members are often the most valued rewards.

Rewarding teams works best when their performance is easily measurable and where the work requires a high level of team behavior.

Pay for organizational performance. Organizations may use three methods of rewarding individuals for organizational performance: bonuses based on profitability of the organization (profit sharing), employee ownership, and gainsharing.

- *Profit Sharing*. Profit sharing is usually based on a formula that measures the organization's overall financial performance. After some base-level of profit is achieved, a percentage of all additional profits is shared. Bonus amounts may be shared among employees as a percent of pay, an equal dollar amount, or based on the level in the organization (higher levels usually get a larger bonus). A fourth approach bases the bonus on individual performance.
- *Employee Ownership*. This pay plan puts some or all of the ownership of an organization into the hands of its employees. Stock options plans, stock purchase plans, stock grant programs, and employee stock options plans (ESOPs) are some of the means to achieve employee ownership.
- *Gainsharing*. In this type of plan, organizations use a formula to share financial gains with all employees in a single location. The organization establishes a historical base period of performance and uses this base to determine whether or not gains in performance have occurred. The popularity of gainsharing is related to features that make it a way of managing and developing organizations. It is a way to foster or reinforce participative management. Studies have shown the following results:
  - Coordination, teamwork and sharing of knowledge are enhanced in the organization.

- Employees' social needs are recognized via participation and mutual reinforcing group behavior.
- Attention is focused on cost savings.
- Acceptance of change due to technology, market, and new methods is greater because higher efficiency leads to bonuses.
- Employees change their attitudes, and they demand more efficient management practices and better planning.
- Employees demand better performance from each other.
- Employees try to work smarter.
- Employees produce ideas as well as physical work.
- When unions are present, union-management relations become more flexible.
- When unions support the plan, they are strengthened because the better work situation and higher pay result from the plan.
- Unorganized locations tend to remain nonunion.

Empirical Evidence

The question of whether or not pay for performance "works" is ultimately an empirical one – does it work where it has been tried? There have been many studies attempting to measure the effect of incentive pay plans on productivity, but none are without flaws which cast doubt on their findings – findings that themselves tend to be weakly supportive at best.[26] That is not to say that pay for performance does not work; rather that its effectiveness is as difficult to measure as the performance itself. After evaluating evidence on profit-sharing plans, employee stock ownership plans, and the influence of employee participation in decision-making, Blinder concludes that "there is good reason to believe that profit sharing does indeed raise productivity;" that the evidence is "particularly persuasive if one accepts the view that a large number of weak, but consistent, studies add up to a strong statistical case;" that "worker participation apparently helps make alternative compensation plans like profit sharing, gainsharing, and ESOPs work better – and also has beneficial effects on its own;" and the overall conclusion that "it appears that changing the way workers are *treated* may boost productivity more than changing the way they are *paid*, although profit sharing or employee stock ownership combined with worker participation may be the best system of all."

. . . effectiveness is as difficult to measure as the performance itself.

[26] Blinder, 1990.

Team-based Pay

Introduction

Flexibility presents the greatest challenge to designers of reward systems . . .

Organizations have adopted team-based work systems, at least in part, because of the flexibility they offer. Flexibility presents the greatest challenge to designers of reward systems, as organizations seek to develop customized reward programs that carefully integrate with the team's work system. Unless the company addresses gaps or contradictions that might limit team or organizational success, it risks losing any gains resulting from the team-based work system. Designing rewards that align with and support the work of a team-based organization is well worth the investment in time and resources. Implementing a reward system that supports the organization's objectives and work system sends a powerful signal about what is important to the company and what it takes for it to achieve success.

Team-based pay is a reward system that nearly everyone can identify with; it rewards teams for achieving specified goals. Individual performance may still be measured, but pay is determined by the performance of the team as a whole. The performance criteria used in team incentives must be under the direct influence of the team. Most team incentives attempt to provide a clear link between outcomes and rewards. This link is often referred to as the "line of sight." As a result, the performance measures among plans vary widely based on the expectations for the team and the nature of the work performed.

Implementing a reward system that supports the organization's objectives and work system sends a powerful signal about what is important to the company.

Companies talk about the benefits of teams. But unless they link the team's success or failure to the employees' bottom line, they aren't ensured of results. Companies are realizing that team-based rewards are crucial to achieving high performance and quality results from teams. Traditional pay-for-individual-performance systems, by their very structure, get in the way of team performance simply because they constitute a force whereby managers regard individuals as individuals, instead of dealing with them in the context of what the team has to do. The most divisive example of this is when colleagues are actually ranked against each other for pay purposes.

Many organizations didn't recognize the importance of changing their human resource support systems – particularly rewards – to align with their new work systems. But when companies changed the dynamics of work from structure-driven – organized around individual roles and functions – to process-driven – often organized around teams – they changed the reward system to support those new dynamics. Team-based rewards can be critical to reinforcing team success. The only way money will effectively influence performance is if employees see the connection between the stated objective and their ability to achieve it. The larger the team, the more important it becomes to supplement the reward with participative initiatives to maintain the link among team members.

Reinforcement is key to effective team-based compensation. Different kinds of teams are suited for specific work cultures. Pay design for each of these team types must vary according to the type of behavior you want to reinforce. Positive reinforcement motivates effort, dispels confusion and eases anxiety. Recognition promotes a sense of team identity by allowing the team to take pride in its progress and accomplishments.

Advantages

- Helps employees unify their efforts.
- Promotes adaptability of skills among the members.
- Improves the collective productivity of the team.
- Encourages teamwork by rewarding team performance.
- Is based on team goals which are easier to devise and track than individual objectives.
- Is easier to administer.
- Provides a clearer link between pay and performance.
- Generates peer pressure for poor performers to improve.
- Introduces variable costs into the pay program.
- Enhances flexibility in job definition and assignment.
- Improves project management.

Disadvantages

- Is subject to "cycling," where the improvements achieved by one team are offset by the poor performance of another.
- Reduces emphasis on individual performance. Poor performers can "hide" behind the performance of the team and will ultimately be rewarded for their poor performance.
- Encourages high performers to slow down so they feel less like they are "carrying" the other team members.
- May pay for performance that might have been achieved without the implementation of a team incentive.

Most Common Problems with Teams

> "Listen carefully and you'll sense a growing unease, a worry that these things are more hassle than their fans let on – that they might even turn around and bite you. It's not that teams don't work. It's that there are lots of obstacles."[27]

[27] Quote by Eileen Appelbaum, author of "The New American Workplace."

The Center for Effective Organizations at the University of Southern California recently conducted a survey of Fortune 1,000 companies showing that 68 percent use self-managed or high-performance teams. But the study also shows that only 10 percent of workers are in such teams, hardly a number betokening a managerial revolution. "People are very naive about how easy it is to create a team. Teams are the Ferraris of work design. They're high performance but high maintenance and expensive."[28]

Companies make teamwork a key issue in an individual's annual performance review.

Pay the team as a group? Then won't your star performers feel slighted? Pay for individual performance? What does that do to encourage teamwork? Companies that use teams best generally still pay members individually, but with a significant difference. They make teamwork, a sharing attitude – the ability to deal well with others – a key issue in an individual's annual performance review. People still want to be acknowledged for their individual contributions, but the problem with this is that it's really hard to separate out what any particular individual really contributes.

One way to do this is to begin to compensate individuals based on the skills and capabilities they bring to the team by replacing the merit-pay system with skill-based pay. Employees continue to be recognized for their individuality, but they can begin to focus on their competencies and what they have to offer the team, instead of worrying about whether their team members are carrying their weight.

ESCA Corporation, an engineering firm in Bellevue, Washington, uses a three-tier team compensation system in which part of the employee's pay is team-based, part of it is organizationally based and part of it is based on individual achievement. To receive their base pay, employees must accumulate and demonstrate career competencies. When more competencies are demonstrated, employees can advance to higher levels within their career path.

Traditional promotions no longer exist at ESCA, and movement among levels, work teams or assignments is not necessarily accompanied by direct or immediate salary action. Instead, employees are considered to be on a pay curve during their employment, and the key to salary or career advancement is expanded knowledge, experience and demonstrated career competencies. Workers advance by demonstrating the behaviors that are described in the company's career competency listing.

Each year, the employees' base salary is adjusted based on their demonstration of competencies. The company also utilizes a team incentive program in which team leaders are given a pool of reward money that is based on how well the team itself performed. Team leaders then award bonuses to members based on their individual contributions. Some members receive bonuses, other may not. The company also gives employees an annual bonus based on how well the corporation did in meeting its overall objectives. ESCA has established an across-the-board pay program by reorganizing into self-managed work teams.

[28] Quote by Edward Lawler, Management professor that oversaw the study at USC.

> Teams often get launched in a vacuum, with little or no training or support, no changes in the design of their work, and no new systems like E-mail to help communication between teams. Frustration mount, and people wind up in endless meetings trying to figure out why they are in a team and what are they expected to do.[29]

"When teams are introduced in combination with other organization changes, they work. When they're introduced as an isolated practice, they fail. Gut feeling is most are introduced in isolation."

"Teams are overused." Many companies will create teams where they're not really needed. They don't realize that workers who are lone wolves or creative types aren't necessarily better off in a team. Making them sit in a team meeting waiting to reach a consensus can even stifle creativity.

. . . compensation must change in support of a new team-based organization, or the organization won't be team-based for long.

The Four Types of Teams

Management teams. Consisting mainly of managers from various functions like sales and production, this type coordinates work among teams.

Work teams. An increasingly popular type, work teams do just that – the daily work. When empowered, they are self-managed teams.

Virtual teams. A characteristic of this new type of work team is that members talk by computer, flying in and out as needed, and take turns as leader.

Quality circles. In danger of extinction, this type, typically made of workers and supervisors, meets intermittently to air workplace problems.

Comments

Changing a compensation system is fraught with risks. After all, people get very emotional when their paychecks are affected. For some employees, pay isn't a dollars-and-cents issue so much as it is a question of how the company regards their contributions. If you don't pay them enough, in other words, you must not value them. Despite the risk, compensation must change in support of a new team-based organization, or the organization won't be team-based for long. Compensation is not just about money. It's about communication.

Compensation is not just about money. It's about communication.

Variable Pay

Introduction

In today's environment, organizations are looking for ways to achieve higher productivity. Many advances have been made in technology and business strategies, but only recently have organizations begun to concentrate on their employees as a means of

[29] Quote by Paul Osterman, a professor of management at MIT's Sloan School.

reaching this goal. Since a large part of many organizations' budgets are spent on payroll costs and benefits, why not use some of this money to improve productivity? The use of variable pay systems is one way to do this.

Variable pay is a means of controlling costs, supporting long-range cultural change, and directing performance toward the accomplishment of specific organizational objectives. A variable pay plan can help an organization do one of three things:

- More or better work with the same number of employees.
- The same or better work with fewer employees.
- More or better work with fewer employees.

Variable pay plans have two common elements. First, individuals or teams receive rewards for specific accomplishments that help the company achieve its goals. Therefore, some portion of pay should be dependent on organizational performance. Second, the payment for those accomplishments does not become part of base pay.

Definition of Variable Pay

Variable pay is an element of compensation that varies with performance. It does not become a part of base pay. In order for a payout to occur, employees must perform to a predefined level. In order for a payout to recur, performance at the predefined level must reoccur. In other words, employees are not entitled to a payout unless they meet a prescribed performance level each measurement period. [30]

Pay is, then, exposed to risk, namely, the risk of not receiving it. Variable pay is also referred to as incentive pay because it encourages, through rewards, activities beneficial to the organization, thus attempting to align employee interests with those of the organization.

There are several issues to consider in trying to implement a variable pay plan. First, ask the question "What are we trying to achieve?" The pay plan must be directed toward accomplishing all or a part of the organization's overall strategy. Some organizations will benefit from variable pay plans, and some may not. Careful thought must be given to ensure the plan will improve performance and to whether it is really necessary or just an administrative burden.

Just as the plan must fit with the organizational strategy, it must also fit with the culture of the organization.

Just as the plan must fit with the organizational strategy, it must also fit with the culture of the organization. A sales division may be very supportive of an incentive plan, but a unionized, bureaucratic organization may resent the differentials that could be introduced. The culture of the organization will also dictate what kind of variable pay plan to implement.

Another important consideration is how work is accomplished in the organization. If work is done by independent teams, then individual incentives may not be appropriate. If, however, work is accomplished by independent salesmen who bring in and cultivate their own customers, an individual incentive plan may be the right way to go.

[30] Compensation Guide.

Finally, and perhaps most important, is the thought given to the basis for the reward. The employee must have a clear picture of what is expected if he is to perform as the company wants. Many organizations implement programs with the best of intentions but fail to consider the possible unintended consequences of the plan.

For example, if a manufacturer were to pay its machinists solely based on the number frame components cut from stock metal tubes, there would be a large increase in the production of frame components, but the machinists might not spend as much time maintaining their equipment and they may change cutting blades more frequently in order to keep the highest level of productivity possible. While this may seem good in the short term, the company may pay for it later when the cutting equipment wears out sooner than expected and more cutting blades have to be ordered because the old ones being thrown out before they are really worn out. This "law of unintended consequences" is an important factor in any incentive program.

This "law of unintended consequences" is an important factor in any incentive program.

An important factor in deciding the basis for a reward is the line of sight. The line of sight is how directly the employee connects the work performed to the reward given. Rewards will most effectively influence performance if employees see clearly the connection between achieving the stated objective – their performance – and what they get for doing it – the reward. For example, if an employee gets a bonus if a certain number of boxes are assembled, the line of sight is very short. The employee knows that if he assembles enough boxes, he gets the reward. However, if the same employee gets a profit sharing bonus based on the overall performance of the company, the line of sight is very long. In this case, it is difficult for him to see how his assembling boxes might cause stock prices to rise or fall.

One of the greatest strengths of variable pay programs over base pay programs is their ability to strengthen the link between performance and rewards and provide a more direct, unobstructed line of sight. By committing to vary pay based on performance, and following through with the promised rewards, an organization will create greater employee motivation.

Employees will continue to perform to those levels that were rewarded and will want to maintain membership in an organization that continues to satisfy their needs. Greater employee job satisfaction, retention and consistently high productivity are the potential paybacks for the organization. Keep in mind that shortening the line of sight can also be accomplished by something as simple as better communicating to the employee how the system works.

. . . shortening the line of sight can also be accomplished by something as simple as better communicating to the employee how the system works.

The Two Major Categories of Variable Pay

Individual incentives. Individual incentives should be used when the opportunity for improvement comes from working harder, not from working differently (for example, on a team vice individually). The organization is paying the individual based on his individual performance. Factors to consider are:

- *Line of Sight*. As described above, the directness of the connection between performance and the corresponding reward is important.
- *Cycling*. Performance cycles can mean uneven payouts.
- *Individual performance measures*. Individual incentive plans work best when used in conjunction with an understandable and effective method of measuring the individual's performance. If performance is not measured accurately, or the employee can not understand how he or she is being evaluated, the incentive plan will lose support.
- *Measures of long-term effectiveness.* Just as the individual's performance must be measured effectively, thought must be given to how to evaluate the effectiveness of the incentive program in accomplishing organizational objectives.
- *Work organization*. Individual incentives should be used when work is done by individuals working separately. Individual incentives should not be used when work is done by teams.
- *Organizational culture*. In order for the plan to be effective, the organizational culture must support individual achievement.

. . . team incentives usually require employees to change the way they work together.

Group or team incentives. Unlike individual incentives, team incentives usually require employees to change the way they work together. In this case, learning new skills (team building) is required to reach the appropriate level of performance. Included in this category are gainsharing and goalsharing plans. Gainsharing measures improvements in performance, then calculate the net financial results of those improvements and share them according to a predetermined formula. Gains are measured in relation to past performance. These rely heavily on employee involvement to maintain line of sight. Goal sharing plans compare performance to future goals. The primary objective of these plans is to reward performance improvements in the business unit. For both types of plans, factors to consider are:

- *Team training*. In order for a team based plan to be effective employees must have training on how to work together as a team. Though this may seem obvious, it is very important in making the plan work. Just throwing a bunch of people together and calling them a team may not bring the desired level of performance and may frustrate efforts to make a variable pay plan work.
- *Line of sight*. Just as in individual plans, this is an important consideration. Additionally, gainsharing plans take time to implement; therefore, time must be spent setting the stage for the new culture. This helps keep the employees focused on what they are working for.
- *Performance measures*. How performance is measured is very important in team based plans just as it is in individual incentive plans.

- *Division of reward pool*. How the reward money is divided among members of the team is also critical in how the plan will be received. In some cases money may be divided equally, and in others more money may go to the people on the team who put in the most effort or are most senior.
- *Employee's effect on performance measures.* Employees must understand how they affect performance measures. Feedback is very important in this process.
- *Cycling*. Teams can experience performance cycles just as individuals do.
- *Team structure*. How a team is organized will determine how an incentive plan might be implemented. Do all members of the team have equal responsibility? Are all members expected to do equal amounts of work?
- *Team function*. What is the team designed to do? Some teams are designed to see a project through from start to finish with relatively stable membership. Some teams are designed to exist over long periods of time and make recommendations. The membership of these teams may fluctuate substantially over time. These factors will affect how the incentive plan is designed.
- *Work organization*. Along with team structure and function, the organizational structure of the organization is important. For example, gain and goal sharing plans work best if the organization is structured in semi-autonomous units. Though some understanding of how what each unit does leads to the final product is helpful, it is not absolutely necessary for the plan to work.
- *Sharing information.* In gain and goal sharing, it is important to share financial information with the employees. This way they understand how what they are doing affects the organization. It also helps them understand the performance measures
- *Organizational culture*. These plans rely heavily on trust between the group of employees and management. In gain and goal sharing plans, communication about the performance objectives and the financial situation of the organization is key to success.

Once the type of plan is determined, there must be some thought given to *how* people are paid. One important distinction is between bonuses and incentives. Bonuses are announced after the occurrence of the performance they are rewarding. There is, therefore, much management discretion involved in their use. They are not necessarily awarded again, nor do they direct the performance of another employee who may wish to earn the same reward. Incentives are announced before performance; therefore, less management discretion is involved. However, they can be used to help achieve a certain goal. Incentives are both motivating and rewarding while bonuses, for the most part, are simply rewarding.

The type of payout is also important. Payouts can occur in the form of cash or stock, or even in the form of a non-cash award. Again, in making this decision, the company must consider what it wants to accomplish. For example, if the goal is to leverage personnel costs and foster a sense of ownership among the employees, a stock option plan might be appropriate. In most circumstances, some combination of these is most effective.

. . . the largest part of variable pay should be results-based.

Turnasella,[31] for example, splits variable pay into two parts: results-based and behavior-based. He contends the largest part of variable pay should be results-based. Results-based pay can be based on either attainment of planned results, or for unplanned outcomes that benefit the organization. The plans that are based on planned results use variable pay as an incentive, usually cash, that is given for reaching a specific objective. The plans based on unplanned outcomes usually award variable pay as awards or bonuses. These can be either cash or non-cash. The other part of variable pay is behavior-based. This pay is given to an employee that exhibits a desired behavior over time and is awarded to communicate to other employees what behaviors are desirable. Usually very few employees receive behavior-based variable pay, and it can given in many forms from spot-bonuses to plaques to paid vacations.

Benefits and Services

This part of compensation includes time off with pay, pay when employment is suspended or terminated, pay when unable to work, payment for medical protection and attention, retirement pay, pay to dependents upon death of employee, and a wide range of desired goods and services from a company car to child and elder dependent care.

Flexible Benefits

Introduction

. . . flexible benefits have become a recognized form of compensating employees.

In the private sector, flexible benefits have become a recognized form of compensating employees. Flexible benefits are defined as those forms of compensation in which the employee has control, either in the degree or in the mix of benefits.

The Revenue Act of 1978 and the Miscellaneous Revenue Act of 1980 approved the use of benefits as non-taxable forms of compensation. The 1978 legislative changes made it possible for eligible employees to select between cash and other currently taxable compensation components or one or more non-taxable components (medical expense insurance, group life insurance plans, disability insurance) and only those components subject to taxes are taxable. Prior to 1978, having the option to select taxable items could make the entire benefits program taxable. The 1980 act further broadened flexible benefits opportunities by granting with this kind of plan the option of having cash or deferred profit sharing arrangements. This enabled companies to offer employees a choice under qualified stock bonus or profit sharing plans between currently taxable cash payments or tax-free deferrals that become taxable when actually paid.[32]

---

[31] Ted Turnasella, “Aligning Pay With Business Strategies and Cultural Values,” *Compensation & Benefits Review*, Vol. 26, Iss. 5 (September 1994), pp. 65-72.

[32] Henderson, 1994, p. 574.

In 1984 the Deficit Equalization Fiscal Reduction Act (DEFRA) restricted the benefits that could be offered under a flexible benefits plan. Employers were permitted to offer only tax-free benefits. Rollovers or cash paybacks of unused benefits to finance future benefits were prohibited. This was designed to block payment of tax-free income. Most existing tax-free benefits remained in effect, but it because difficult to qualify new benefits as tax free. DEFRA authorized the following benefits in a cafeteria plan: cash, group term life insurance, accident and health coverage, dependent care assistance, deferrals into 401(k) plans, and vacations. Non-qualifying benefits are any noncash benefit that is taxable income to the employee, scholarships and fellowships, van pooling, educational assistance, employee discounts, free parking, and meals and lodging for the employer's convenience.

Finally, the Tax Reform Act of 1986 (TRA 86) clarified the question of taxability by authorizing non-taxable flexible benefits, including salary reduction as not subject to FICA or other taxes so long as there was no discrimination in favor of the highly compensated. Since then, the use of benefits in general has increased. Thirty to forty percent or more of an employee's compensation may be in the form of benefits.

Categories

The major categories of flexible benefits are:

- health insurance
- disability income benefits
- death benefits
- time off with pay
- retirement capital accumulation plans

Other categories less frequently treated as flexible are:

- dental plans
- option for vision and hearing exams
- life insurance
- accidental death and dismemberment insurance
- survivor income insurance
- dependent's life insurance
- financial planning option
- stock purchase plan
- purchase of extra vacation time
- tuition aid plan for dependents
- educational assistance plan for employees (including travel expenses)

Advantages

- As a non-taxable form of compensation per the Revenue Act of 1978, it benefits employees in higher tax brackets the most.
- Accommodates the needs of widely heterogeneous workers.
- Accommodates employee needs without adding new benefit costs.
- Gives a sense of limit on total benefits without denying specific coverage.
- Assists in recruitment, retention, absenteeism, etc., because it is often viewed as an indication of an innovative, people-oriented company.
- Giving employees choices is inherently rewarding in itself.
- Because of the company's buying power, the perceived value of the benefits to the employee may be greater than the company's actual cost.
- Gives employees a sense of "ownership" in the firm's compensation system, and thus in the entire firm as a result.
- The broader the selection of flexible benefits, the greater the opportunity for the employee to gain intrinsic rewards.
- Provides the opportunity to meet a hierarchy of employee's needs (Maslow's theory). Creates an intrinsically rewarding atmosphere by allowing employees to satisfy basic safety and survival needs first, then interpersonal needs, and finally personal, self-actualized needs.

Disadvantages

- Flexible benefits are still the exception rather than the norm. Some companies may feel uncomfortable with less standardized forms of compensation.
- Start up costs of changing to a new system.
- Maintenance costs (equipment and personnel resources) to input employee changes to the flexible benefits mix and costs to educate the employee.
- Flexible benefits may be "carved out" of the existing benefits. If so, the result may be a reduction in the pre-flex plan level of benefits.
- Decisions on core coverage (namely, minimum levels of each flexible benefit, such as minimum $10,000 life insurance and 2 weeks vacation) must be made before implementation. Without such coverage, employees may exclude "vital" coverage's such as health insurance which may have a negative impact on the employer in the long term.
- Some employees may not be capable or comfortable choosing benefits. The company must decide whether to create a default selection of flexible benefits.

Conditions Under Which Flexible Benefits Work Well

- Largely independent of organizational structure and human resource management philosophy. Works well in almost every structure.
- Particularly effective if the employee has the ability to periodically review and update his/her benefits mix. This can be accomplished electronically at modest cost.
- In organizations where longevity is valued, longer time-in-service can be rewarded by increasing the level of benefits.
- In flat organizations with fewer promotion opportunities, the level of benefits can substitute for a new title or other trappings of promotion.
- In organizations with a majority of employees in higher tax brackets, tax-advantaged benefits have extra value.

Conditions Under Which Flexible Benefits Do Not Work Well

- Less effective in organizations with mostly transient workers.
- Less popular in organizations where cash benefits are disproportionately valued.
- Of questionable value for employees who are unable or unwilling to determine the most valuable mix of benefits to meet their needs.
- Could become a negative form of compensation if employer is inflexible in allowing changes, doesn't help educate employees on details of program, or doesn't present the program as a change which will benefit employees.
- In paternalistic companies, giving immature, uninformed employees significant control of benefits can be disconcerting.

Derivatives

Cost sharing. Employees are offered opportunity to purchase supplemental benefits at a cost lower than what they would be charged if purchased individually. Tax free status may not apply.

Personal discounts. Using the buying power of the company, employees enjoy discount prices on insurance (car, home, household goods, etc.), computer equipment, daycare, recreation (equipment, vacations, tickets, club membership). Administrative cost to employer may be offset by a boost in morale, productivity and loyalty.

Employee spending accounts (ESA). A tax-free reimbursement account that moderates or reduces the costs of benefits for the employee while giving the employer greater control over expenditures. These can be substitutes or supplements to a flexible benefits program. Employees convert a portion of taxable wages into nontaxable

[33] Henderson, 1994, pp. 576-577.

dollars to pay for specific benefits such as medical expense reimbursement (including dental and optometry), insurance premiums, dependent care assistance, legal services, and personal financial planning. This permits employers to shift some of the premium costs and increase deductibles and co-payments. And social security and unemployment taxes are reduced. The IRS requires that employees elect their benefits before the beginning of the plan year, that they not change during the year (except due to a change in family status), that they make separate selections for medical expenses and other services, and that they use the benefits in the plan year only and forfeit unused amounts.[33]

Medical and Dental Benefits

Introduction

In a 1986 survey of 812 major employers,[34] all offered medical coverage. The typical coverage included a deductible of $200 or less, a $1000 annual cap, and some level of employee contribution. The same survey showed that 89 percent of employers provide dental coverage, 21 percent vision care, and 6 percent hearing care.

Benefits of medical coverage are directly enjoyed by both the employee and employer. Health care costs have increased faster than the cost of living, influencing the trend toward joint employee-employer contributions. Another reason for the increase is an increased rate of utilization.

The demographic trend toward two income families sometimes results in redundant medical coverage. Flexible compensation plans allow married employees to adjust their level of coverage.

Basic Plans

Medical indemnity plans. The most traditional. The employer determines the coverage levels and the employee selects the service provider, for example, doctors, hospitals, dentists, etc.

Preferred provider organization (PPO). Networks of providers that agree to discount their normal fees in return for an anticipated increase in volume. Typical discounts are 5-15 percent of normal fee.

Health maintenance organization (HMO). Groups of physicians and other health professionals from whom patients seek a broad range of care for a set fee. HMOs may also cover dental, vision and hearing services. They have met with some success in reducing costs in civilian practice.

Health care flexible spending accounts. A pretax source of reimbursement to the employee for out-of-pocket medical expenditures. Considered a fourth type of health care coverage.

---

[34] D. Gifford and C. Seltz, *Fundamentals of Flexible Compensation* (New York, NY: John Wiley and Sons, 1988), p. 6.

Current Military Health Care System

Purpose and Status

- Maintain the health of military personnel in order to carry out missions.
- Be prepared to deliver health care during war time.
- On space available basis, provide health care services to dependents, and retirees and their dependents.
- Using CHAMPUS (Civilian Health and Medical Program), the military equivalent of a health care plan, reimburse beneficiaries a portion of the cost of health care received from civilian providers.
- Estimate: 8.3 million eligible people covered in FY 1995 by the Military Health Services System (MHSS).
- Estimate: In FY-95, the Department of Defense will spend $15.2 billion for health care, $3.9 billion of which is for CHAMPUS. [35]
- Military Treatment Facilities consist of 127 hospitals and 504 clinics.
- CHAMPUS Reform Initiative (CRI) launched in 1988 due to budget growth and user dissatisfaction. Implemented in CA and HI. Nation-wide by 1997.

TRICARE (Triple-option Health Care Plan)

TRICARE is a form of managed care designed to contain health care costs through constraints on access to specialists and limitations placed on lengths of stay in hospitals. Usually managed care is controlled by health management organizations (HMOs). TRICARE is a regionalized military managed care program for members of the uniformed services and their families, and survivors and retired members and their families. TRICARE was introduced for the following reasons:

- Cost Containment: CHAMPUS budgets continue to grow despite downsizing. Reasons: civilian medical care costs rise, growing number of retirees eligible for CHAMPUS, closing of military hospitals forces retirees and dependents to use civilian care.
- Complicated CHAMPUS procedures (uncertainties of space-availability, extent of reimbursement for given charges, deductibles, paperwork, and waits for reimbursement).
- Perception of high, unpredictable out-of-pocket costs.
- Few incentives for beneficiaries to control costs since a large percentage of bill is reimbursed. (Military dependents/retirees do make heavier use of medical services than most Americans.)

---

[35] R. Best, *Military Medical Care Services: Questions and Answers* (Washington, DC: Library of Congress, 1994), p. CRS-2.

It consists of three programs:

- **TRICARE Prime.** Used like a typical HMO with required enrollment. Primary Care Manager (PCM) provides/coordinates all medical needs. Care is from MTF (Military Treatment Facility) or from approved network of civilian providers only. Small co-payments by beneficiaries for each visit to a civilian network provider, but not to MTF. No claims forms, no deductibles, no enrollment fees for active duty and dependents. Retirees and family pay annual enrollment fee. Includes preventative health care (routine physicals, immunizations), education and counseling services, provisions to use providers without an authorization, but at significantly higher cost sharing than with TRICARE Standard. Active duty personnel are automatically enrolled in this option. Medicare eligible beneficiaries not eligible for enrollment in Prime at present. May still seek care from MTFs on space available basis. This could change if Medicare Subvention law is passed.
- **TRICARE Extra.** Used like a preferred provider network (where a network of physicians agree to offer health services for a discounted fee) with choice of selecting own health care provider. No enrollment fees. Can be used on case-by-case basis. Usually no claim forms to file. Network providers accept negotiated rates and cost share as payment in full (after appropriate deductible is met). Users have greater choice of doctors. Can even chose doctor. BUT, must accept higher charges. Costs 5 percent less than TRICARE Standard (after deductible is met) for outpatient visits and also less for inpatient stays. Use of MTFs (Military Treatment Facilities) on space available basis at no cost.
- **TRICARE Standard.** Similar to standard CHAMPUS Fee for service plan (fees are paid when services are obtained) Maximum choice of health care providers, but highest out-of-pocket cost (includes deductibles and co-payments). No enrollment requirements. Use of MTFs on space available basis at no cost.

Options that Could be Incorporated into TRICARE

Flexible Benefits

- Offered primarily to contain or reduce health care costs and to satisfy diverse needs of work force.
- Most companies use a comprehensive medical approach.
- Differences in deductibles and maximum out-of-pocket amounts.
- The following items frequently do NOT change from one option to another within a company: coinsurance, lifetime maximums on benefits, covered expenses. An alternative delivery system (for example, HMOs) may be offered, but even that does not usually affect type of care provided. [36]

---

[36] Gifford and Seltz, p. 24.

Medical Savings Plans

Employee spending accounts (ESAs) or health spending accounts (HSAs) can be a substitute or supplement to a flexible benefits program. A tax-free reimbursement account that moderates or reduces the costs of benefits for the employee while giving the employer greater control over expenditures. Employees convert a portion of taxable wages into nontaxable dollars to pay for medical expenses not otherwise covered (for example, dental, optometry, well baby care, physical exams or orthodonture). An alternative plan has the employer purchase catastrophic insurance with a large deductible (for example, $3,000 and then deposit that same amount in the medical savings account). Note: savings plans may also be used to fund other types of needs such as insurance premiums, dependent care assistance, legal services and personal financial planning.

ADVANTAGES

- Since the funds are used at the employee's discretion, the responsibility for health choices revert to the consumer.
- Employees can compare services and products.
- Employees can tailor their own type of health care (HMO, PPO, or any combination). [37]

DISADVANTAGES

- May discourage some from seeking preventive care and care during early stages of illness, potentially leading to higher costs in the long term.
- In plans requiring employee contributions, the worker may seek care up to but not beyond the employer's contribution, ignoring needed medical attention.

Because the plan uses pre-tax benefits, social security and unemployment taxes are reduced. The IRS does require that employees elect their benefits before the beginning of the plan year, that they not change during the year (except due to a change in family status), that they make separate selections for medical expenses and other services, and that they use the benefits in the plan year only. Unused amounts may be left in the medical savings account, taken as income, deposited in an interest bearing account for future expenses, or contributed to an under-funded 401(k) plan or IRA. Some of these options have tax consequences. [38]

IMPORTANT ELEMENTS OF A MEDICAL SAVINGS ACCOUNT HEALTH BENEFITS PROGRAM

- Medical savings account;
- Catastrophic, high-deductible medical coverage;
- Incentives for healthy lifestyles, for example, cash incentives to participate in health promotion/illness prevention programs;

[37] S. Barchet, J. Anderson and L. Chapman, "Medical Savings Accounts," *ACA Journal,* Vol. 4, No. 3 (Autumn 1995), pp. 34-47.
[38] Henderson, 1994, p. 576-7 and Barchet, 1995, p. 40.

- Wellness and prevention programs, for example, preventive medical exams, immunizations, and diagnostic tests;
- Clinical and resource support management;
- Efficient administration;
- Communication and education; and
- Implementation, monitoring, and evaluation.[39]

OPT OUT CHOICE/HIGH AND LOW CHOICES

Employers vary in allowing waivers. Some set minimal core level coverage. This is more common with medical than dental coverage. Examples of options: High cost – 100 percent coverage for hospitalization and 80/20 percent sharing of medical costs. Low cost – Coverage for hospitalization with deductible and co-payments and 70/30 percent sharing of medical costs.[40] Most employees who waive medical coverage have another source of coverage, such as spouse's policy.

CASH REWARDS TO EMPLOYEES WHO FILE FEW OR NO CLAIMS

Often paired with high deductible plans to dramatically reduce costs. A derivation of this is well-day incentives – days added to vacation time upon attainment of wellness achievements.[41]

Dental Care

- Dental care represents only about 10 percent of total health care costs in US, and dental costs are increasing slower than medical costs.
- While 83 percent of employers surveyed allowed a choice of dental coverage[42] most often the choice is yes or no, to elect or refuse coverage. Some employers offer a choice of two plans, one providing lower coverage in all areas, or one plan having different coverage emphasis (for example, checkups and cleanings, but not major services).
- Dental HMO enrollment is increasing. Advantage is no deductibles or annual limits on care. No claim forms, costs guaranteed. HMOs emphasize prevention. Costs generally 10-30 percent lower than dental indemnity plans.[43]
- Employers are encouraging workers to use benefits regularly in order to avoid costly problems later.

---

[39] Barchet, 1995, p. 40.
[40] M. Manin, "Successfully Administering Flex Plans," *HRFOCUS* (April 1995), p. 7.
[41] Barchet, 1995, pp. 39, 43.
[42] Gifford and Seltz, 1988, p. 236.
[43] K. Robbins, "Dental Plans are Growing in Popularity," *Business and Health*, Vol. 12 (2 Dental care supplement), (February 1994), p. 4.

Vision Coverage

- Third most popular benefit after medical and dental.
- Although increasing (26 percent of organizations surveyed in 1988 had a vision care plan), percentage is still fairly low.[44]
- More often covered as part of health savings account.

Roles and Missions Commission Recommendations

- Users of military medical care should be given the option to use more private care, thus permitting downsizing of the peacetime military medical establishment.[45]
- Any changes in the military medical program must ensure high accessibility to quality care for all beneficiaries at no cost to active duty personnel, at no increased cost on average to active duty families, and at reasonable cost to retirees and their families.[46]
- Require beneficiaries who choose to use military medicine to enroll in the DoD-sponsored health care plan of their choice. Establish a reasonable fee structure for care received by non-active duty beneficiaries through all DoD-sponsored sources.[47]
- For active duty military families, provide a regular medical allowance equal to the average out-of-pocket costs to offset fees.[48]

Retirement

Background

Retirement is ultimately an issue of how individuals who no longer work fund their living. From roughly 1930 to 1960 the system was fairly stable with three levels of retirement income sources: social security, pension and personal savings. Social Security provided minimum subsistence, a pension on top of social security allowed a comfortable living, and personal savings on top of the other two provided the means to live the good life. The retirement system is now in a period of transition, however.

While there are many opinions on social security, demographics alone dictate that 21st-century social security will be different from what it is now. Either recipients will receive less or workers will have to put more into the system. Privatization – essentially switching to an IRA-type system – is not unthinkable. Chile has done so quite successfully.

---

[44] Hay, 1988, p. 132.
[45] *Directions for Defense*, Report of the Commission on Roles and Missions of the Armed Forces (advance copy) May 25, 1995, p. 3-11.
[46] *Directions for Defense,* p. 3-12.
[47] *Directions for Defense,* p. 3-13.
[48] *Directions for Defense,* p. 3-13.

Employers that offer traditional pensions (defined-benefit plans) are steadily declining. An increasing number of employers offer defined-contribution plans where the employer only compensates for retirement if the employee has contributed to his or her own retirement. Some companies offer no retirement compensation at all. All in all, it is a complex subject with many implications for an organization.

The retirement spectrum is best described by picturing the defined-benefit plan at one end and the defined-contribution plan at the other with any number of possible hybrids in between. A classic defined-benefit plan is the traditional pension; the classic defined-contribution plan is the 401(k).

Vesting. Vesting is an important concept. An employee is "vested," entitled to retirement benefits, after working for an employer a specified number of years. Vesting was unregulated – left to the employers discretion – until 1983 when vesting was required after five years of service in order to qualify for employer tax benefits for the retirement plans. Prior to 1983 "most employers required at least 25 years of continuous service before an employee had the right to start collecting pension benefits at the prescribed retirement age, which was almost always age 65. [49]

A major reason for the move to shortened vesting was the declining average length of service with the same company. "When Social Security laws were first passed in the 1930s, the average employee worked for one company for about 20 years, based on the sketchy data that was then available. By 1980, the average length of service had fallen to less than ten years. By 1986, the average employee worked for one company for six years. Unless the vesting period was reduced, few workers would collect under any pension plan." [50]

The Defined-benefit Plan

Background. The traditional pension is a defined-benefit plan. The employee gets a regular check for life upon reaching a certain age, typically 65. The pension can be indexed to the Consumer Price Index (CPI), so that the pension value is protected against inflation. The pension is tax-sheltered. In other words, a company is not taxed for the money it sets aside for employee retirement. The company sets aside retirement money into a pension fund, a professional financial consultant manages the fund, and the retirement benefits the worker receives comes out of that fund. By law, the pension fund manager is fiscally responsible to the shareholders. The individual does not pay taxes on the retirement money until he or she starts receiving retirement checks. The standard company contribution is 7 percent of annual salary.

Strengths

- The employee is essentially guaranteed a monthly retirement check.
- There are often ancillary benefits. For example, payments for disabled workers and to the surviving spouses of workers who die before reaching retirement age.

[49] Sibson, p. 222.
[50] Ibid.

- The employee is insulated from risk; however, the organization's pension fund is subject to the risk of the market.
- A traditional pension combined with late vesting provides a greater long-term retention incentive than defined-contribution.

Weaknesses

- Declining availability.
- Company defined-benefit plans and social security alone may not fund retirement.
- With the option of taking pension accumulation in a lump sum, financial hardship after quickly spending the lump sum may occur.
- The traditional standard pension plan paid retirees a fixed monthly check.
- "Fewer employers will bear the financial risks and regulatory hassles of defined-benefit plans." [51]

Method of payment. One new development in defined-benefit plans is the method of payment. "About a third of big companies that offer the familiar, monthly-check-for-life pensions, such as Merck & Co. and Digital Equipment Corp., now give departing employees the option of taking their pension accumulations in a lump sum when they retire, change jobs or are laid off. By the end of the decade, experts predict about half of old-style pensions will be distributed this way. Lump sums are cheaper for employers to provide than a string of retirement checks because they don't entail continuing administrative expenses or premium payments to the government's Pension Benefit Guaranty Corp." [52]

Defined-contribution

Background. The 401(k) plan is named for the part of the tax code that authorizes employees to set aside untaxed dollars in a special account and that encourages employers to match what employees contribute.

"Congress added 401(k) plans to the Internal Revenue Code to create a device for accumulating savings and other capital on a tax-deferred basis. Often, the plans allow an employee to borrow from accumulated funds under 'hardship' conditions, when emergency medical services are needed and for educational purposes. However, Congress has not, to our knowledge, characterized 401(k) plans as substitutes for traditional pension plans, whose purpose is to pay a lifetime retirement income." [53]

The 401(k) plans offer such investment options as company stock and selected mutual funds. They also offer Guaranteed Investment Contracts (GIC). GICs are primarily fixed-interest-rate options like a CD, except they are sold by insurance companies rather than banks.

---

[51] Ibid.
[52] Ellen E. Schultz, "Offered a Lump Sum, Many Retirees Blow It And Risk Their Future," Wall Street Journal, 31 July 1995, sec. A, p. 1.
[53] McGinn Actuaries Ltd. Letter.

Withdrawals from the 401(k) are taxed above the return of any after-tax contributions. If the individual is under 55, there is a 10 percent penalty on the taxable amount also. Other options are to leave it in the company plan, transfer it to a 401(k) of the new employer, or shift money to an IRA.

Typically, employers match 50 cents for every $1 the employee invests, up to 6 percent of salary. Nearly all 401(k) plans permit “hardship” withdrawals for such things as buying a home, paying for college or medical care. Most also permit the employee to borrow from the account. The interest rate is usually the prime rate or prime plus one percentage point. In most cases, the interest goes back into the account.

Companies often require their employees to work a set number of years to qualify for the employee contribution accruing in their 401(k)s. One popular method is to vest 20 percent of the contributions the first year on the job, and 20 percent more each year until full vesting after five years.[54]

Strengths

- Portability – 401(k) plans follow the employee.
- Automatic salary deduction often is one of the best ways to save for retirement.
- Employees leaving employment significantly prior to normal retirement age will do better under a defined-contribution plan.

Weaknesses

- Provides no ancillary benefits. If a worker dies, his or her spouse receives only what has accumulated in the 401(k) account.[55]
- Amount of 401(k) balance is not guaranteed but is subject to market forces. There is no direct correlation between the value of an account balance and the amount of monthly income needed at retirement, disability or death.[56]
- “Experience has shown that very few employees leave employment and use their 401(k) plan balance to buy an annuity or roll over the funds to provide retirement benefits. Most spend their entire account balances on impulse items. Fewer than 5 percent purchase annuities.”[57]
- Allowing people easier access to their savings undermines saving for retirement.
- Most working Americans do not have the information they need to maximize their investment returns. There is a widespread lack of knowledge about the basics of investing.[58]

---

[54] David J. Morrow, “What’s It Worth to You? How to put a Price Tag on your Company’s Perks,” *Smart Money*, April 1994, pp. 133-136.
[55] McGinn Actuaries Ltd. Letter.
[56] McGinn Actuaries Ltd. Letter.
[57] McGinn Actuaries Ltd. Letter.
[58] “Many Are Unprepared for Retirement,” Compensation Guide: Benefits and Compensation Update June 1995, Vol. 2, No. 6, p. 3.

Current military retirement system. The current military retirement system is a defined-benefit plan. Individuals vest after 20 years and receive an annuity from the date of retirement. The amount is a percentage of their base pay at separation indexed for inflation. The system has been modified twice in recent years (1980 and 1986), both changes reducing the value of the overall retirement. These changes were grandfathered, applying only to those coming into the service after the change.

CHAPTER 4
PRIVATE SECTOR COMPENSATION TRENDS

Renaissance In Compensation

. . . organizations have started turning to compensation as a means of affecting organizational performance.

In the past few years, organizations have started turning to compensation as a means of affecting organizational performance. Companies are engaged in "broad experimentation with different ways of rewarding people, and a recognition that traditional programs may no longer be appropriate."[59] This chapter summarizes some of the trends in compensation.

Use of Compensation to Gain a Competitive Advantage

In the fiercely competitive private sector, compensation is increasingly recognized as an area that might be exploited to yield a competitive advantage. Edward E. Lawler III uses this as a premise and proposes tailoring compensation strategies to support the organization's strategy.[60] Judging from the large attendance at a recent American Compensation Association conference, mainly by company representatives looking for ideas or success stories along those lines, it is a new idea that is becoming widely accepted.

Total compensation, also known as total remuneration, includes anything of economic value to employees, whether provided directly by a company or mandated by the government. Total remuneration elements include: base compensation, incentives, bonuses, health and disability benefits, death and accident benefits, retirement, savings plans and other tax favored programs, etc. For an organization to achieve competitive advantage using total compensation, it must answer three key questions:

- What is the current cost and value of your total renumeration package?
- How does this benchmark with relevant comparators?
- What is the optimal mix of total renumeration elements?

A key is to ensure that employees understand the value of all forms of remuneration they receive.

A key is to ensure that employees understand the value of all forms of remuneration they receive.

Employee Ownership and Involvement

There is a growing emphasis on employee ownership and involvement. The idea, of course, is that the employee will perform better with a stake in the company. There are a number of ways to implement this. One is compensating with stock or stock

[59] *Compensation Guide,* December 1994.
[60] Lawler, 1990.

options instead of cash. Another is by requiring executives to acquire a certain amount of the company's stock. A third way is when employees buy a large share of a company near ruin in an effort to save the company. In this case though, the company probably needs more than increased employee performance to survive.

Putting Pay At Risk

"There is an increasing commitment to pay-at-risk programs on the part of most organizations. Part of this is because such programs provide some cost control by avoiding ever-increasing base salaries. A more important value of at-risk programs is the performance focus they provide to employees. A well-designed at-risk program specifies both desired outcomes and desired ways of reaching those outcomes. Such programs can focus either on individual performance or group performance. The variety of at-risk programs is increasing, as is the percentage of salary budget devoted to these programs. The relatively large amount of space devoted to at-risk compensation programs in Compensation Guide compared to the space devoted to traditional compensation systems indicates the increasing centrality of alternative rewards." [61]

A well-designed at-risk program specifies both desired outcomes and desired ways of reaching those outcomes.

Shorter Vesting Periods

Time to vest, the period an employee is required to work to qualify for retirement benefits, has greatly decreased. Vesting has moved from 30 to five years in the private sector, and full portability is on the horizon. The driving factor in this trend is the declining average length of service with a single company. This trend has a major, negative impact on an organization's retention.

Move from Defined-benefit Plans to Defined-contribution Plans

There is a definite trend away from the traditional pension plans to defined-contribution plans, especially with smaller companies. There is a good business explanation for this. Pensions' plans are a losing proposition for a company. They are expensive and "involve risks that are not acceptable for the prudent employer." [62] This trend also implies a shift in retirement responsibility from the government and employer being totally responsible for an employee's retirement. The employee is becoming increasingly responsible for his or her own retirement with matching funds from the employer. The idea of control over their own destiny is attractive to many employees. The downside, of course, is that the employees must live with the results of their own decisions; there is no one to bail them out if they fail.

The employee is becoming increasingly responsible for his or her own retirement with matching funds from the employer.

Choice

In the past, the organization has dictated to the individual exactly what the compensation will be. Increasingly, the individual is being afforded the ability to make

[61] *Compensation Guide,* December 1994.
[62] Retirement Plans.

compensation-related choices and decisions. Some examples are cafeteria-style benefit selection, medical savings accounts, 401(k) plan options, etc. An employee may also have a menu of retirement, health care, and benefit plans to choose from. One major factor in this trend is the increased availability of information to all employees from the CEO to entry level. Another might be the transition from the industrial age worker to the knowledge worker.

Additional Trends

. . . the application in an organization should depend on how well they contribute to the strategic intent of the organization.

Listed below is a compilation of compensation examples and methods. The items listed represent those considered to be the most thought-provoking, the most innovative, and the most worthy of further discussion. Further, they may have applicability to the uniformed services. However, although they are “best” in this sense, the application in an organization should depend on how well they contribute to the strategic intent of the organization. What works well for one organization does not necessarily imply it will work well for another organization.

Medical Savings Accounts

Medical savings accounts usually involve both employee and company contributions. The company pays the first $1500 of medical bills and the individual pays the next $1500. Catastrophic insurance coverage pays any additional bills. Normally pre-tax advantages apply.

Flexible Benefit Plans

This plan allows employees a choice in selecting the type and amount of benefits to suit their needs. Most common choices are health benefits, death benefits and time off with pay. Others include dental, vision and hearing benefits, dependent life insurance, financial planning and educational assistance.

Sabbaticals

As a form of compensation, individuals could be offered extended leave (paid or unpaid) to pursue further education, travel, charity work or other pursuits.

Enhanced Educational Opportunities

Provide individuals with greater educational and training opportunities. Increase quotas to existing schools, establish remote campuses, or design interactive computer classes (distance learning). May be tied to concept of pay-for-skill or pay-for-knowledge.

Leave of Absence for Family Obligations

Similar to sabbaticals, this is extended leave for the care of newborns, ailing family members, etc. This provides individuals the opportunity to take leaves of absence in order to resolve temporary family issues.

Extended Career Opportunities

Restructuring the policy on mandatory retirement could allow full-time active duty careers beyond 30 years or part-time “emeritus” relationships for positions requiring experience and tenure for senior commissioned, warrant, and chief petty officers. Options for these part-time roles include expenses-only advisory role, “board of advisors” position, consultant, and member of interview boards for initial entry into the service.

Flex-time and Part-time Work Schedules

Flex-time, as used in many federal agencies, does not affect total hours worked. Rather it permits employees to tailor work hours and work days to best satisfy their personal preferences. As an alternative to flex-time, part time schedules enable members to meet pressing obligations such as long-term family needs.

Flexible Work Location Plans and Work at Home Plans

Remote work sites reduce employee commutes. Exploiting technology and communication advances enables employees to complete at least a portion of their office responsibilities from their residences.

Wellness and Fitness Programs for Employees and Dependents

Examples of wellness programs are company-sponsored and supported fitness facilities, presentations and newsletters on wellness, discounts and outings to recreation sites such as ski slopes and pools, etc. Insurance discounts for non-smokers and fitness center members could be offered.

Wellness Medical Care

The emphasis is preventative care and a healthy, knowledgeable work force. Commonly seen in HMOs and dental plans, these plans often include immunizations, education and counseling.

Defined-contribution Retirement Plans

A defined-contribution plan is beneficial to both employers and employees for reasons noted above. Organizations have increasingly moved to 401(k)-type plans for that reason.

Most employees are vested in defined-contribution plans after five years. Full portability, no vesting period at all, is probably not far in the future. Short or no vesting at all removes an incentive to remain with the same employer.

CHAPTER 5
PRINCIPLES OF MILITARY COMPENSATION

Introduction

A compensation system needs a firm base to stand on. This base can be represented by a list of principles of compensation. In its final report, the 7th QRMC stated, "Compensation principles should serve a long-term purpose much like military doctrine: a foundation of theory, philosophy and widely held enduring beliefs to guide both policy and management." Principles are necessary and should represent the core values and beliefs of the organization as they relate to compensation.

Compensation principles might equate to an organization's mission and vision. By serving as an overarching guide, principles align the most important values with an organizational compensation strategy and, in turn, with specific forms of compensation. For example, if the uniformed services value *equity* and *fairness* as important principles of compensation, a compensation strategy might be to employ standardized pay scales across large segments of the service population, establish clearly defined promotion criteria, and minimize the amount of pay for performance.

Specific forms of compensation might be a standard pay table, a restriction on paying bonuses for particular assignments, and allowing choice in the type and amount of benefits received. Lawler states, "The core reward system principles that an organization develops should represent a standard for the organization – that is, the organization should always test its behavior against them. They are something that the organization gives to the employee that allows the employee to trust and depend upon the reward system commitments of the organization."[63]

Compensation principles should present a crystal clear picture of what an organization values.

Compensation principles should present a crystal clear picture of what an organization values. This is not always the case. Just as individuals have competing interests, so do the uniformed services. As an example, equity and flexibility are principles somewhat in opposition. Individuals value base pay and other non-variable income for its equity. Yet they also strive for individual recognition through promotion, personal awards, and choice assignments. That is, they value the compensation system's flexibility. Compensation principles should prioritize the most important values of the organization and ensure those are the ones most richly rewarded.

The principles recommended by the 7th QRMC are listed below. Two additional principles are suggested.

[63] Lawler, 1990, pp. 39-40.

The 7th QRMC's Principles of Compensation

Effective in Peace and War

The compensation system must allow for the smooth transition of active, reserve, and retired forces from peacetime to mobilization status. The system must be designed to accommodate the rapid expansion and contraction of forces.

Equitable and Efficient

Must be perceived to be equitable by the member and efficient by the taxpayer.

Flexible and Competitive

Must provide the flexibility necessary to sustain the skill and force mix objectives, to compete with the private sector, and to deal with revised manpower goals.

Motivational

Must encourage productivity and reward advancement. Because the military is a closed personnel system, whose members perform highly specialized tasks, the compensation system must adequately recognize the value of experience.

Predictable

The system, to remain attractive over time, generally must provide lifetime remuneration promised at the outset of a member's career. Predictability entails both system design at a given time and policy commitment over time.

Understandable

Should be as easy to understand as possible to foster national support and member commitment.

Two additional principles appear useful in designing compensation systems for the 21st century.

Participative and Accessible

Every member of the uniformed services, whether active duty, retired, reserve, guard, or auxiliary should know that they can receive answers to their compensation questions. The uniformed services should view this particular principle as a form of compensation in itself; service members value the ability to receive accurate, timely information. Technological advances make this possible in a low-cost manner. In addition, members of the uniformed services should feel that their opinions and perspectives regarding the compensation they receive are valued by the services in decision making. Choice and preference empower employees and are satisfiers in themselves. Lawler states, "The reward system practices in large organizations are particularly prone to creating the feeling that the organization is highly bureaucratic and that individuals are cogs in the system rather than drivers of the organization." [64] To the maximum extent possible, a compensation system should incorporate the characteristics of accessibility and participation.

Transportable

As members of the uniformed services change status from active duty to reserve or to retiree, they should be assured that their benefits travel with them. Many corporations provide nearly identical *types* of benefits to all employees, regardless of their status. The uniformed services also recognize this concept in areas such as exchange and commissary privileges, medical care, and Space A travel. Note that while *types* of benefits are similar, the *degree and terms* of the benefits may vary. Retirees, for instance, may pay more for the health care they receive; and reservists may be limited in the frequency of their commissary visits. Nevertheless, the concept of transportability adds validity to the principle of "effective in peace and war." Additionally it supports the principles of predictability and equity.

Proposed 8th QRMC Principles of Military Compensation

Both the 5th and the 7th QRMC published principles of military compensation. Based on their work, the 8th QRMC proposes the following updated set of principles of compensation.

Effective Throughout the Spectrum of Military Operations

The compensation system should work transparently throughout the spectrum of military operations from peacetime to global warfare. When the armed forces must mobilize, the senior leadership has to be able to devote their full attention to fighting the war and must not be distracted by compensation issues. Likewise, all service members should be able to direct their full attention to warfighting without financial distractions.

Equitable

Must pay members at a level that fosters self-esteem and allows them to enjoy a decent standard of living similar. Pay should not have a negative effect on the ability of the member to perform his or her duty.

[64] Lawler, 1990, p. 32.

Financially Responsible

The compensation system must assure the taxpayer that neither more nor less is being spent than required for an effective force and to provide for the common defense.

Flexible

The compensation system must provide the flexibility necessary to sustain skill and force mix objectives, the ability to compete with the private sector under changing market conditions, and to deal with revised manpower goals that result from changes in mission, the geopolitical situation, or technology.

Encourage Retention

Given the unique hardships attendant upon military service, the compensation system must encourage sufficient people to remain in the military to provide the needed level of experience.

Dependable

The compensation system must provide the remuneration promised at the outset of a member's career. This principle entails both system design at a given time and policy commitment over time.

Understandable

Military members should understand their compensation system, and the pertinent information should be both accessible and easily understood. The military should be open and honest in its discussion of pay to foster national support and member commitment. Every member of the uniformed services, whether active duty, retired, reserve, guard, or auxiliary should know that they can receive answers to their compensation questions. In addition, members of the uniformed services should feel that their opinions and perspectives regarding the compensation they receive are valued by the services in decision making. To the maximum extent possible, the compensation system should incorporate the characteristics of accessibility and participation.

CHAPTER 6
SYSTEMS MAPPING

Introduction

The numerous compensation options detailed in earlier chapters have both intended and unintended consequences. It is important that an organization considers both consequences to accurately assess the effect of a policy or practice.

One highly effective method of capturing both beneficial and detrimental consequences is to look at the compensation alternatives as part of a system and to apply some of the principles and techniques of systems thinking. Briefly, systems thinking is a discipline for seeing wholes.[65] That is, it emphasizes relationships between the components in a system and how the interaction of these components moves the whole system. It specifically attempts to remove the distinction between dependent and independent variables, preferring to view all variable as dependent on some or all of the components of the system.

Several archetypes describe recurring system patterns that exhibit similar relationships between components. Two archetypes particularly useful in examining the consequences of a compensation system are "shifting the burden" and "fixes that fail." Both these archetypes provide a visual description of the intended and unintended consequences of a particular plan and a logical framework to explain why the effect may be smaller than anticipated.

Shifting the Burden

The shifting the burden archetype describes a situation where the solution to a problem only addresses a symptom of the fundamental problem. Furthermore, the "symptomatic solution" has the added drawback of exacerbating the "fundamental problem." A good example of this is a case of addiction. Many people seek relief from the stress they are experiencing through alcohol, drugs or smoking. They choose the relief of their preferred substance that in the short run provides the temporary relief. However, there is a side effect; and that is the damage done to their health that causes a reduced capacity to deal with stressful situations. Stress is reduced in the short run, but the cause of the stress is never dealt with, and there is a degradation of health. All of this combines to make the situation much worse despite the short term relief.

---

[65] Peter M. Senge, *The Fifth Discipline: The Art and Practice of the Learning Organization* (New York, NY: Doubleday, 1990), p. 68.

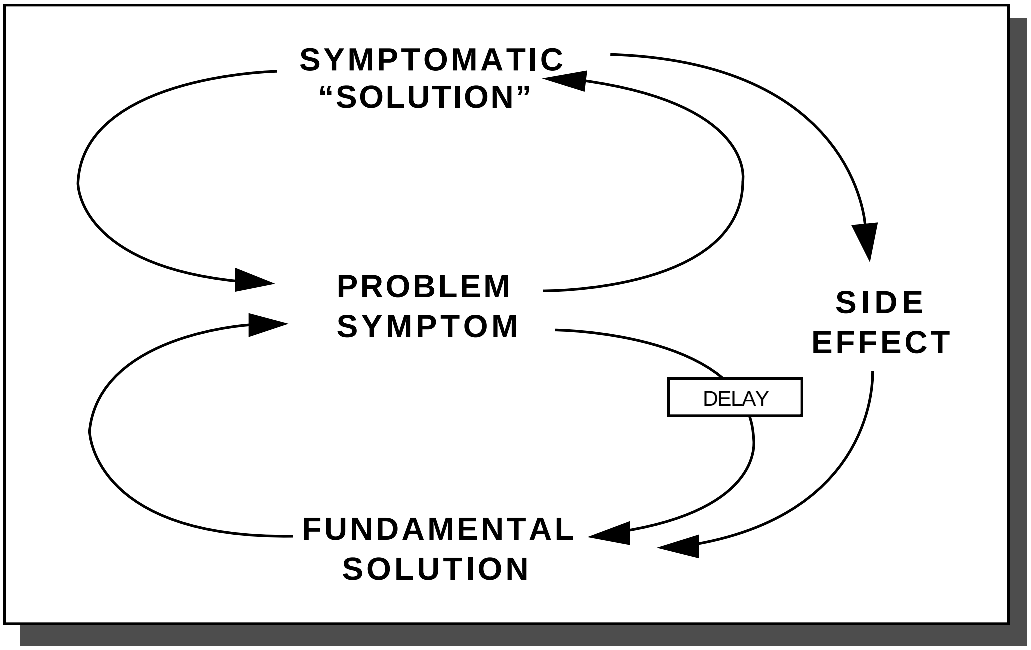


Figure 6 – Shifting the Burden

Poorly administered profit and gainsharing plans can become an addiction for employees caught in them. The diagram below illustrates the potential trap.

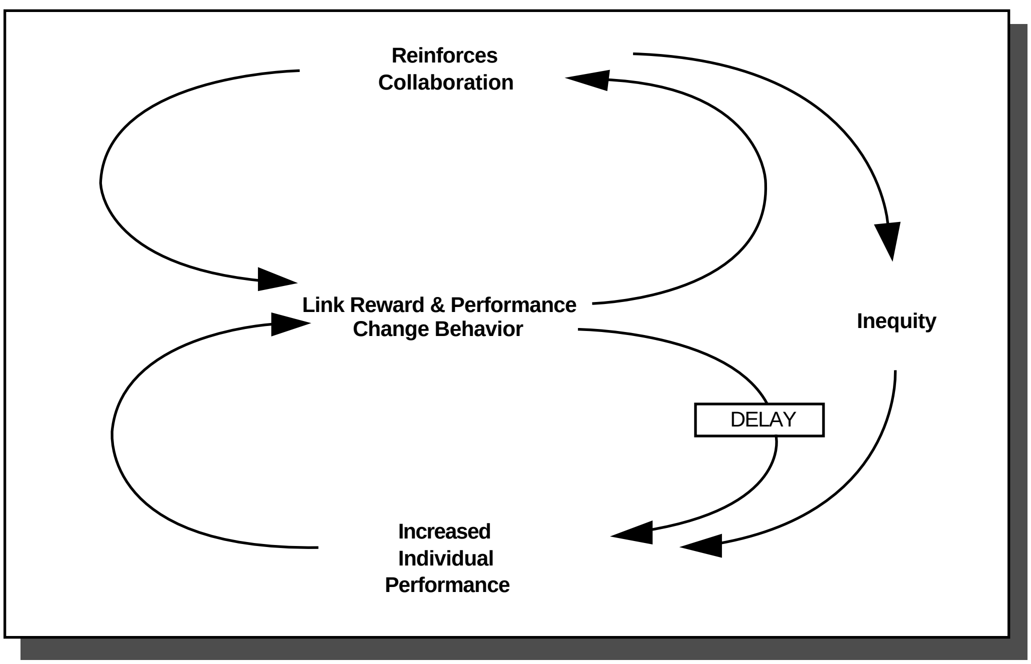


Figure 7 – Gainsharing as Shifting the Burden

In this example profit and gainsharing plans are administered for the purpose of improving productivity by explicitly linking group rewards with performance. The plan initially reinforces collaboration increasing productivity for the organization. Over time, however, workers notice that some of their colleagues contribute less and are receiving the same reward. This inequity may cause others in the organization to shirk, resulting in a number of people performing at a lower level than before implementation.

There is no way to tell whether general productivity will increase, decrease or stay the same. What can be said with confidence is that plans to increase productivity through profit or gainsharing will overestimate the expected results if the detrimental effect of shirking is not considered. Likewise, understanding the potential pitfalls of this type of plan will alert managers to what may be going wrong before things get out of hand, and help them to formulate strategies for corrective action.

Fixes That Fail

As was the case with the "Shifting The Burden" archetype, "Fixes That Fail" describes a situation where the fix has both intended and unintended effects. The unintended consequences are difficult to notice in the beginning, but after some delay what was initially resolving the problem has made the problem worse, and no amount of energy applied to the fix has any capacity to resolve the problem. Examples of "fixes that fail" are common, borrowing to pay interest on debts, or reducing preventative maintenance to save money, both lead to more of what is causing the problem that must be resolved.

Pay for performance schemes can be a "Fix That Fails" if improperly implemented:

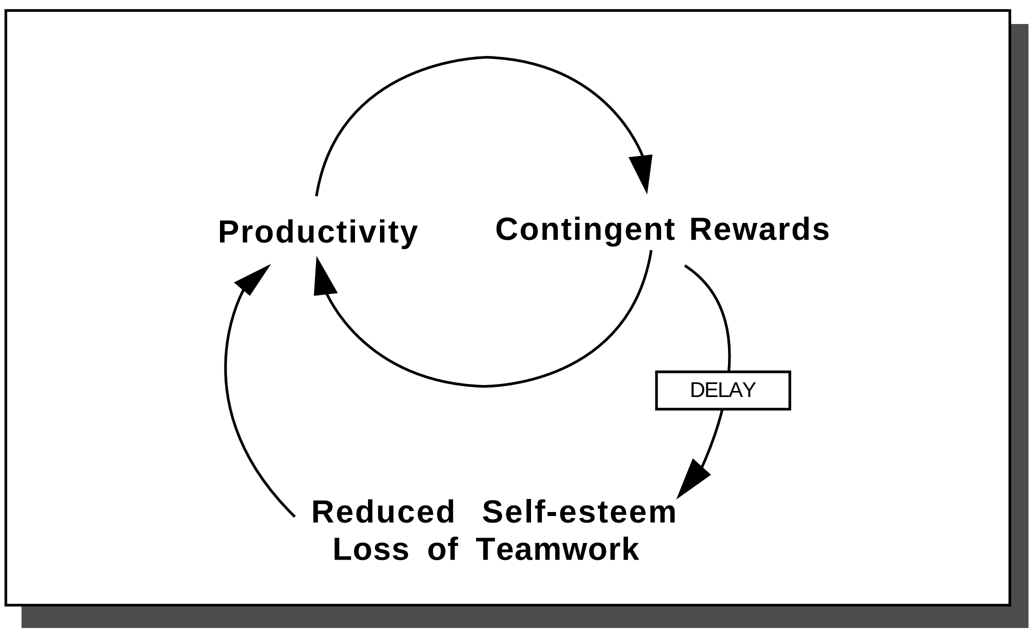


Figure 8 – Pay for Performance as Fix That Fails

Tragedy of the Commons

Teamed based pay strategies suffers a similar drawback as the one described by profit and gainsharing plans. The problem is one associated with communal property rights described in systems thinking by the "Tragedy of the Commons."

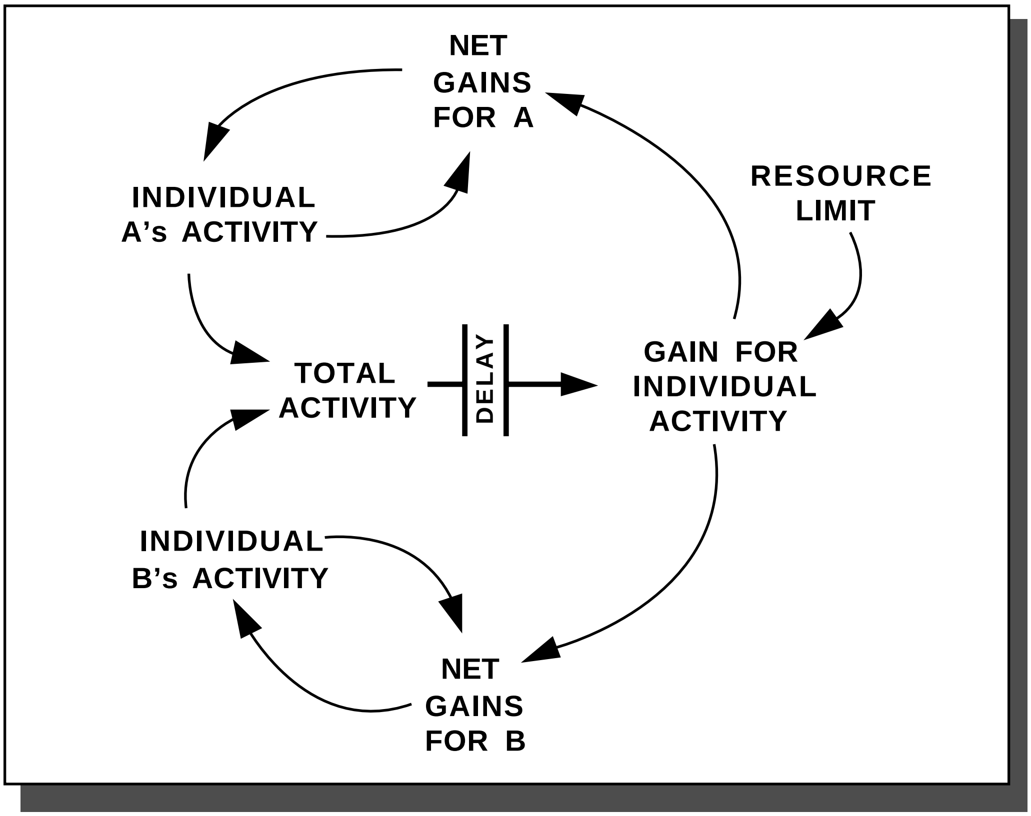


Figure 9 – Team-based Pay as Tragedy of the Commons

The Tragedy of the Commons archetype is illustrated by a situation where a number of dairy farmers all own small plots of land and have communal rights to common area. Each farmer realizes that he can preserve some of his grass land if he puts a few head of cattle out in the common area. He makes his decision of how many cattle to put in the common area based on the number of cattle he would put on a similar plot of land if he owned it himself. The problem is that all the farmers make the same decision and over time the common area is over grazed and eventually no cattle can be sustained in the common area.

Team based pays can potentially suffer the same fate. Each member of the team realizes that their shirking will only result in a fractional decrease in their team based reward. For instance, if a team of 100 people is rewarded $100 for every for every widget assembled and assembly takes a half day, a natural value of a person's labor in this industry is $200 per day.

This arrangement, however, leads to a perverse incentive system. If one person chooses to socialize or relax and is only able to assemble one widget per day he and every one else receives the standard $200 minus the lack of contribution by the one shirking individual, in this case $1, resulting in a total team based pay of $199 per person.

The perverse incentive is obvious when you note that the shirking individual gained a half day of recreation (a $100 value) for the cost to him of one dollar – a very attractive bargain. Likewise the person who would assemble more than his quota of widgets gets a very poor return on his efforts. If he is able to produce a third widget he and everyone else will receive the $200 plus one additional dollar for a total of $201. In this situation the $100 of effort is rewarded to the individual performing it with $1 of compensation.

Game theory also provides a template to describe this situation. The Prisoner's Dilemma describes a situation in which two suspected criminals are brought in for separate questioning on a robbery case. The detective tells each one that if he confesses to the crime implicating his partner, he will receive a reduced sentence of one year and his partner will receive the maximum sentence of 25 years; if they both confess, they will receive a stiff sentence of 20 years; and if neither confess, they will be charged with a greatly reduced crime carrying a five-year sentence. The payoff matrix faced by the suspects is as follows:

		Prisoner B	
		Confess	Don't Confess
Prisoner A	Confess	(20, 20)	(1, 25)
	Don't Confess	(25, 1)	(5, 5)

What is curious about this decision matrix is that even if each prisoner knew the choice that his partner had made he would choose to confess. This is not a probabilistic model, if Prisoner A knows with 100 percent confidence that Prisoner B will choose to confess, he should choose to confess (20<25). If Prisoner A knows with 100 percent confidence that Prisoner B will choose not to confess, he should still choose to confess (1<5). The socially preferred outcome is unachievable without a mechanism to ensure cooperation.

This model can also be used to illustrate the choice a worker faces in the poorly implemented team based pay system describe above.

		Coworkers 2-100	
		Shirk	Don't Shirk
Worker 1	Shirk	(100, 100)	(199, 199)
	Don't Shirk	(101, 101)	(200, 200)

This payoff matrix has the interesting property that the payoffs in the shirk/shirk and don't shirk/don't shirk cells are identical but the pressures of the system will cause all 100 workers to choose to shirk. Specifically worker will see that 200>101 and 199<200 (only slightly less than 200) and, therefore, he chooses to shirk regardless of what the others choose. This same observation can be made of the 99 other workers.

BIBLIOGRAPHY

Anthony, William P., Pamela L. Perrewe, and K. Michele Kacmar. *Strategic Human Resource Management*. Orlando, FL: Harcourt Brace Jovanovich, 1993.

Barchet, S., J. Anderson and L. Chapman. "Medical Savings Accounts." *ACA Journal*, Vol. 4, No. 3 (Autumn 1995).

Beatty, Kate L. "Pay and Benefits Break Away from Tradition." *HRMagazine*, Vol. 39, Iss. 11 (November 1994), pp. 63-68.

Belcher, John G., Jr. "Gainsharing and Variable Pay: The State of the Art." *Compensation & Benefits Review*, Vol. 26, Iss. 3 (May 1994), pp. 50-60.

Best, R. *Military Medical Care Services: Questions and Answers.* Washington, DC: Library of Congress, Congressional Research Service, 1994.

Brown, C. "Dental Benefits: Setting Objectives, Picking A Plan." *Employee Benefit Plan Review*, Vol. 49, Iss. 9 (March 1995).

Caudron, Shari. "Master the Compensation Maze." *Personnel Journal* (June 1993), pp. 64B-64O.

Charles, J. "Health Benefits: Here And Now." *Benefits Canada*, Vol. 18, No. 10 (November 1994), pp. 27-31.

"Commission Releases Recommendations For Health Care Reform." *The Retired Officer Magazine* (July 1995), p. 16.

Davidson, Craig J. "Strategic Planning Programs: A Compensation Perspective." *Benefits Quarterly* (First Quarter 1995), pp. 25-32.

"Dental Benefits Market Has Evolved, But Where Is It Headed?" *Employee Benefit Plan Review*, Vol. 48, No. 9 (March 1994).

Directions for Defense, *Report of the Commission on Roles and Missions of the Armed Forces,* (advance copy) May 25, 1995.

Dolmat-Connell, Jack. "A New Paradigm for Compensation and Benefits Competitiveness." *Compensation & Benefits Review* (September-October 1994), pp. 51-64.

Ewers, A. "Multiple Perspectives: A Series of Essays About the Impact of Shifting Public Benefits Policy on Employers." *ACA Journal,* Vol. 4, No. 3 (Autumn 1995), pp. 22-24.

Fay, Charles H. "Emerging Trends And Challenges In Compensation." *Compensation Guide* (June 1995) pp. 1-3 to 1-28.

"Flex Contained Health Costs For Most Employers." *Employee Benefit Plan Review*, Vol. 48, No. 11 (May 1994).

Gibson, Virgina M. "Align People with Business Strategies." *HRFocus*, Vol. 72, Iss. 3 (March 1995), pp. 12-13.

Gifford, D. and C. Seltz. *Fundamentals of Flexible Compensation*. New York, NY: John Wiley and Sons, 1988.

Hannon, Kerry. "Where the Real Raises Are." *Working Woman*, Vol. 19, Iss. 3 (March 1994), pp. 48-51, 72, 96.

The Hay Group. "Changing Benefits Trends." *Compensation and Benefits Strategies for 1995 and Beyond.* Philadelphia, PA: The Hay Report, 1994.

Hellriegel, Don, John W. Slocum, Jr. and Richard W. Woodman. *Organizational Behavior.* St. Paul, Minnesota: West, 1983.

Henderson, Richard I. *Compensation Management.* 6th Ed. Englewood Cliffs, NJ: Prentice-Hall, 1994.

Heshizer, B. "The Impact of Flexible Benefits Plans on Job Satisfaction, Organizational Commitment and Turnover Intentions." *Benefits Quarterly* (fourth quarter, 1994), pp. 84-90.

Jimerfield, C. "Examples of Flexible Benefits Programs In Eight Companies." 7th *QRMC Background Papers*, 1991 (File 88).

Johnson, Cathe and Kathleen McNally. "Managing Variable Pay Systems." *Compensation Guide*, December 1994, Chapter 33.

Kanin-Lovers, J. and Parr, S. "Developing a Total Compensation Approach," *Compensation Guide*. Boston, MA: Warren, Gorham & Lamont, 1994, pp. 2-7 - 2-8.

Kirwan, John P., Jr. "Use Empowerment for Bottom-Line Results." *HRFocus*, Vol. 72, Iss. 1 (January 1995), p. 19.

Larson, Ruth. "Anti-deficit Group Calls U.S. Pensions Unaffordable Luxury: Military System Singled Out For Reform." *Washington Times*, 11 July 95, sec. A, p. 6.

Lawler, Edward E., III. *Strategic Pay: Aligning Organizational Strategies and Pay Stystems.* San Francisco, CA: Jossey-Bass, 1990.

Lawler, Edward E., III. *The Ultimate Advantage: Creating The Involvement Organization.* San Francisco, CA: Jossey-Bass, 1992.

Leonard, B. "Perks Give Way to Life-cycle Benefits Plans." *HRMagazine*, Vol. 40, No. 3 (March 1995), pp. 45-48.

Lockwood, D. "Allocating The Cost of Fringe Benefits." *Management Accounting*, Vol. 76 No. 5 (November 1994), pp. 50-53.

Manin, M. "Successfully Administering Flex Plans." *HRFOCUS* (April 1995), p. 7.

"Many Are Unprepared for Retirement." *Compensation Guide: Benefits and Compensation Update*, Vol. 2, No. 6 (June 1995), p. 3.

Markowich, M. Michael. "Use Compensation As a Strategic Weapon." *HRFocus*, Vol. 71, Iss. 8 (August 1994), pp. 12-13.

McAdams, Jane B. "Determining Pay Rates and Managing Pay Structures." *Compensation Guide* (1995).

McAdams, Jerry L. and Elizabeth Hawk. "A Strategic Use of Employee Assets." *ACA Journal* Vol. 3 (Autumn 1994), pp. 46-59.

McAdams, Jerry L., and Elizabeth Hawk. *Capitalizing on Human Assets.* Scottsdale, AZ: American Compensation Association, 1994.

McCoy, Thomas J. *Compensation and Motivation*. New York, NY: AMACOM, 1992.

Morrow, David J. "What's It Worth to You? How To Put A Price Tag On Your Company's Perks," *Smart Money* (April 1994), pp. 133-136.

Moyer, H. and C. Armstrong. "Time To Cut Health Care Costs." *Benefits and Compensation Solutions* (May 1995), pp. 36-37.

Rabin, B. "Assessing Employee Benefit Satisfaction Under Flexible Benefits." *Compensation & Benefits Management,* Vol. 10, No. 3 (Summer 1994), pp. 33-44.

Robbins, K. "Dental Plans Are Growing In Popularity." *Business and Health,* Vol. 12 (2 Dental care supplement) (February 1994), p. 4-6.

Santone, Thomas J., Kevin J. Sigler and Raymond Britt. "The Strategic Compensation Planning Process." *Benefits Quarterly* (Fourth Quarter, 1993), pp. 85-96

Schiffres, Manuel and Melynda Dovel Wilcox. "401(k): 12 Keys to Success." *Kiplinger's Personal Finance Magazine* (May 1993), pp. 37-43.

Schultz, Ellen E. "Offered a Lump Sum, Many Retirees Blow It And Risk Their Future." Wall Street Journal, 31 July 1995, sec. A, p. 1.

Schuster, Jay R. and Patricia K. Zingheim. *The New Pay: Linking Employee and Organizational Performance.* New York, NY: Lexington Books,1992.

Schuster, Jay R. and Patricia K. Zingheim. "'New Pay' Strategies That Work." *Journal of Compensation and Benefits* (May-June 1993), pp. 5-9.

Schuster, Jay R. and Patricia K. Zingheim. "The New Variable Pay: Key Design Issues." *Compensation & Benefits Review* (March-April 1993), pp. 27-34.

Senge, Peter M. *The Fifth Discipline: The Art and Practice of the Learning Organization.* New York, NY: Doubleday, 1990, p. 68.

"Shedding Light on the Facts: Readiness, Entitlements, The Military Retirement System." Supplement to the Retired Officer Magazine. December 1994.

Stanton, Erwin. "Reality-Centered People Management Key to Improved Productivity." American Management Association, 1982.

"Successfully Administering Flex Plans." *HRFOCUS*, April 1995, p. 7.

Sibson, Robert E. *Compensation.* 5th ed. New York, NY: American Management Association, 1990.

Sullivan, John F. *The Components, Cost Structure and Objectives of a Total Compensation Program*. Scottsdale, AZ: American Compensation Association, 1991.

"That was the Workweek that was: Dow Chemical joins a Parade of Companies Clocking Out from the Traditional 5-day, 40-hour Employee Schedule." *Washington Post*, October 15, 1995, p. H4.

The Bureau of National Affairs, Compensation & Benefits Library on CD. Washington, DC: The Bureau of National Affairs, 1993.

"The Great Benefits Reprieve." *Kiplinger's Personal Finance Magazine* (December 1994), p. 15.

"The Rudder," National Naval Medical Center (NNMC) Marketing Department, May 1995, Iss. I.

Thomas, Kenneth, and Erik Jansen. "Intrinsic Motivation in the Military, Part I: Models and Strategic Importance." Draft paper for the Eighth Quadrennial Review of Military Compensation, December 1995.

Tritch, T. "These Tax Cuts Could Save You Plenty." *Money* (September 1995), pp. 22-23.

Turnasella, Ted. "Aligning Pay With Business Strategies and Cultural Values." *Compensation & Benefits Review*, Vol. 26, Iss. 5 (September 1994), pp. 65-72.

US Department of Labor, Bureau of Labor Statistics (June 1990) *Employee Benefits In Medium And Large Firms*, 1989, Bulletin 2363.

Wilhelm, R. "Taming the Flexible Beast." *Benefits Canada*, Vol. 18, No. 1 (January 1994), pp. 27-28.

William M. Mercer, Inc. *Employee Performance Pay*. New York, NY: 1995.